PREFATORY NOTE

These transcripts have been produced from the original raw transcripts in the FOMC Secretariat's files. The Secretariat has lightly edited the originals to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcripts were not fully edited for accuracy at the time they were produced because they were intended only as an aid to the Secretariat in preparing the records of the Committee's policy actions. The edited transcripts have not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee

July 5-6, 1989

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, July 5, 1989, at 3:00 p.m., and continuing on Thursday, July 6, 1989, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Guffey
Mr. Johnson
Mr. Keehn
Mr. Kelley
Mr. LaWare
Mr. Melzer
Ms. Seger
Mr. Syron

Messrs. Boehne, Boykin, Hoskins, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Black, Forrestal, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Assistant Secretary
Mr. Gillum, Deputy Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Patrikis,[1] Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Balbach, R. Davis, T. Davis, Lindsey, Promisel, Scheld, Siegman, and Simpson, Associate Economists

Mr. Cross, Manager for Foreign Operations, System Open Market Account

1. Attended Thursday session only.

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Mr. Stockton, Assistant Director, Division of Research and Statistics, Board of Governors
Mr. Keleher, Assistant to Governor Johnson, Office of Board Members, Board of Governors
Mr. Wajid,[2] Office of Board Members, Board of Governors
Mr. Hooper,[3] Assistant Director, Division of International Finance, Board of Governors
Ms. Danker,[3] Section Chief, Division of Monetary Affairs, Board of Governors
Mr. Mahoney,[3] Senior Economist, Division of Monetary Affairs, Board of Governors
Mr. Teplin,[3] Economist, Division of Research and Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Beebe, Broaddus, J. Davis, Lang, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, Cleveland, Philadelphia, and Dallas, respectively

Ms. Lovett and Mr. McNees, Vice Presidents, Federal Reserve Banks of New York and Boston, respectively

Mr. Vangel, Assistant Vice President, Federal Reserve Bank of New York

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

Ms. Rosenbaum, Research Officer, Federal Reserve Bank of Atlanta

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2. Attended Thursday session only.
3. Attended portion of the meeting relating to the Committee's discussion of the economic outlook and its longer-run objectives for monetary and debt aggregates.

Transcript of Federal Open Market Committee Meeting of
July 5-6, 1989

July 5, 1989--Afternoon Session

CHAIRMAN GREENSPAN. Good afternoon, everyone. Ed Boehne is in transit. Apparently the train broke down or something unbelievable happened; he's driving in and should be here in about one-half hour. But let's move forward. Would somebody like to move approval of the previous meeting's minutes?

MS. SEGER. I'll move it.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. Mr. Cross, would you bring us up to date on your operations?

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Are there any questions for Mr. Cross? Lee.

MR. HOSKINS. Sam, on the warehousing agreement: When was that done and do we review it regularly at this Committee?

MR. CROSS. We review it every year. It was reviewed in March of this year and reestablished without change, as has been done for many years--ever since I've been here.

MR. TRUMAN. There were similar arrangements that we used in the early 1970s.

MR. HOSKINS. Is that ever questioned by Congress as a way to circumvent the limit that's placed on the [Exchange Stabilization] Fund?

MR. TRUMAN. To my knowledge Congress has never raised any questions about it. It was established more or less permanently in the late 1970s when the Treasury issued Carter bonds and they wanted to simply [make permanent] that limit and wanted to monetize the Carter bonds; so we held them from that point. It was carefully examined by the Committee at that time and [the decision] was made public; since then we've continued the arrangement. It is reviewed at the March organizational meeting.

MR. HOSKINS. It's reviewed and voted on?

MR. CROSS. Yes.

CHAIRMAN GREENSPAN. Do we have statutory limits?

MR. TRUMAN. No, the $5 billion limit is a limit that the FOMC imposed.

CHAIRMAN GREENSPAN. But Lee is asking--

MR. HOSKINS. I thought the limit was imposed by Congress.

MR. CROSS. No.

MR. TRUMAN. No. I took your comment to mean that a limit is imposed by Congress in that the balance sheet of the ESF is in some sense controlled by Congress. It was last voted on by Congress I think in the 1930s but implicitly also, I guess, when they voted on the SDR [amendment to the IMF Articles].

MR. HOSKINS. Then why do we have to go through a warehousing arrangement? You could just allow them to increase the Fund.

MR. TRUMAN. Because there is a practical limit on the [Fund], which is the size of their balance sheet. They have dollars that were originally acquired at the time gold was--

MR. CROSS. The devaluation of gold in 1933.

MR. TRUMAN. The dollar amount was set up in the Exchange Stabilization Fund then; it has been used periodically for a variety of things and they also hold U.S. SDRs. Congress did review this issue in the context of the approval of the SDRs. In the first amendment to the [Articles of] Agreement in the late 1960s, they authorized the ESF to transfer to the Federal Reserve SDR certificates which, in effect, allows them to monetize those SDRs. In that sense, they again reviewed that source of the ESF funding itself. But that's the last time I know of that it was formally reviewed.

MR. CROSS. The logic in a sense is not too different from what the Treasury and the Central Bank have. Even when the gold flowed into the country then you were allowed to issue those certificates and receive dollars for them. We no longer have the gold flows; we have foreign exchange flows. And this, in a sense, is a similar allowance for the Treasury to monetize these assets and gain the dollars for them.

CHAIRMAN GREENSPAN. There's also another implicit issue here: namely, that there's a pro forma 50/50 split. If that split were not there we could do it all and they would not do anything. So, it's merely a question for them of being able to maintain their 50 percent share of the intervention that's involved. So it's not a circumvention of any statute or convention; it's merely the result of the arithmetic of the limits of the ESF plus a desire on the part of the Treasury to maintain the 50/50 split. The only way it can be done is through the warehousing operation. I should say it's one of the ways; there are other ways.

MR. HOSKINS. There are other ways they can get Congressional approval for more money for the Fund. I'm not asking anybody to do that, but it seems to me that to some extent we've got something out of whack here. Either the Fund is too small relative to the size of operations we're currently conducting--

MR. CROSS. It isn't the Fund. What this does is to shift the assets in the Fund; it doesn't change the size of the Fund. It allows them to transfer one asset to another asset.

MR. HOSKINS. I understand that. Well, let me ask you another question, Sam.

MR. TRUMAN. It is true, as the Chairman commented, that until the late 1970s, all the foreign exchange held by the United States--what little we had--was held by the Federal Reserve. So this issue didn't come up in that context. The Treasury didn't get into the holding of foreign exchange balances except with respect to their own lending operations until the late 1970s.

MR. HOSKINS. Are they accumulating [unintelligible] now? Sam, is that sufficient?

MR. CROSS. Yes. The dollar has been declining now for several weeks and we're about 8 or 9 percent down from the highs. We still have more than $2 billion availability under the open limit.

CHAIRMAN GREENSPAN. Do we run into a headroom problem there?

MR. CROSS. Pardon me?

CHAIRMAN GREENSPAN. Do we run into a headroom problem there? In other words, has the dollar decline--

MR. TRUMAN. No, it's at historical rates.

MR. CROSS. We value it on the basis at which we have actually made a transaction; so we don't change it when the exchange rates change. That is the only way we can do it because, if we didn't handle it that way, we could inadvertently run out of leeway with nothing happening.

MR. ANGELL. Sam, to what extent did you use banks to execute the orders in such a manner that the market would not have immediately recognized it as a central bank order?

MR. CROSS. Well, during this period we did most of it in what we call a discreet manner. That is to say, we operated through a bank acting as an agent so that--although the word does get around in some way and people who are following these markets closely can often tell a lot of what's going on--we did not go in openly buying foreign currencies. For the most part we had particular banks operating on our behalf in order not to show the extent to which the central banks were in there. We had gotten to a point where operating visibly was not really working very effectively and we thought it would be better to operate this way. Indeed, it has been much more successful. Remember, the other central banks have done the same thing, following our doing it. The Germans most recently, and the Japanese too, have been operating in a discreet manner.

MR. ANGELL. Do you think you were able to buy more cheaply by buying discreetly than if you had bought openly? Did you buy the portfolio--

MR. CROSS. I think it was a lot more effective because we had reached a point where the market tended to feel that these rates were out of control--well, not out of control but beyond the ranges that the authorities wanted. And when they saw the central bank coming in there they almost took that as a basis [for believing] that the dollar was by definition undervalued. And they tended to hit it quickly. Now, in operating more discreetly we have been able to kind of encourage the dollar down without appearing to try to take on the market in a direct way. Under certain conditions one technique is more appropriate and under other circumstances another way is. We have felt during this period, given the market conditions that we faced, that this was the better way to operate. And I think that has proved to be the case.

MR. ANGELL. Well, Mr. Chairman I would make a comment: I just do not agree that it's appropriate for us to act in ways that are intended to confuse the markets or mislead the markets. I believe that markets work best when all participants have information as to what's going on. I am not a strong believer [in the view] that it made the difference because you did it in a discreet fashion lately. My guess would be that if you had operated discreetly during the previous period and you operated openly during this period you'd have found out that an open way would have worked in a better fashion. I just don't hold that these kinds of moves make that much difference. But even if they did, I do not believe it's appropriate for a government agency in a market society to be acting in such a manner. It's not appropriate for us; I believe it opens up the possibility for the charge of someone privately benefitting from what we do. So, Mr. Chairman, I would register not a dissent from the actions but an indication that if that were to continue I think I would have to object.

MR. TRUMAN. Governor Angell, Sam does make a regular report on Desk operations [public] every three months. It's not as if the operations are--

CHAIRMAN GREENSPAN. Give me a scenario in which private parties--

MR. ANGELL. Well, when we operate in securities transactions at the foreign Desk in what I would call the normal manner that we use at the open market Desk we would be indicating to a group--to more than one participant--what the Fed is doing. And they could all have a chance to participate. When you start choosing one bank to be your agent it seems to me it opens up possibilities.

CHAIRMAN GREENSPAN. You're saying that that individual bank may choose to--

MR. ANGELL. Well, yes. And we have--

MR. CROSS. Let me say a couple of things. First, even when we're operating openly we may go to, say, 5 banks out of 100--whatever the number is. So it's not as though we operate in the way the domestic Desk does and broadcast [our operations]; we never do that. We operate with a certain--we go out to do the transaction. Secondly, when we've operated discreetly we have done that with a bank on the understanding that they not reveal this information or talk to other parts of their institution and so forth. Now, obviously the word--

CHAIRMAN GREENSPAN. I believe Governor Angell was raising the question as to whether the individual bank trades on that information, which is not available to other participants in the market.

MR. CROSS. Well, in a sense, a bank can do that any time we are in the market and are trading with a bank. As I say, if we are operating quite openly we might go out and talk to 5 banks or 10 banks. They might choose to join us, and this helps move the market in the direction [we want] if they're convinced that it's going that way. We do move around from one institution to another; we don't use the same one, obviously. Sometimes we might use several at once, but we do it in a way that they are not supposed to go tell all their customers and others that they are operating on behalf of the Fed.

MR. ANGELL. I prefer to be operating in markets in which self interest is assumed to be the motivating factor for the parties we're dealing with rather than to be operating under the assumption that someone is going to be behaving in the manner that suits our interests and that might be against their own self interest.

MR. CROSS. Anybody who is operating to suit our interest against their own interest is going to end up in the hardware business or something pretty soon. I don't think any of them do that.

MR. ANGELL. Well, in addition to the possibility of something occurring that would give an impression of being inappropriate--in regard to a favorable opportunity for one bank or one trader--I still would hold that it's always best to let markets know what it is we're doing and to try to buy at the best price. And it seems to me that buying at the best price--

MR. CROSS. We do buy at the best price.

MR. TRUMAN. Governor Angell, we're doing it at the best price but within the limit. If you want to take your rule to the limit--if [buying at the best price] was the objective--then we should have been talking up the dollar for weeks and then Sam could have gone in and bought the foreign exchange cheap. The objective was not to minimize the price at which we picked up yen and DM balances; for better or for worse, it was to limit the rise of the dollar. That doesn't necessarily always mean picking up the [best price]; you can't have it both ways.

MR. CROSS. We were trying to influence the market; that doesn't mean we were trying to fool the market. But I don't know that it would follow that we always have to tell everybody in the market every time we operate. That seems to me to be a different matter.

MR. ANGELL. Well, I realize that a bully has more clout at times than does someone who plays according to the rules. But central banks have considerable power. And it seems to me they should operate in an open and clear fashion that gives participants access to information in a timely manner and does not seek to confuse. My view, Mr. Chairman, is that operating as we did tended to disrupt the normal market processes, including the price of gold. And I think it was unnecessary and undesirable. That's all I have to say.

MR. HOSKINS. Just a question. It may be more appropriate for you, [Mr. Chairman]. It seems to me, if I've done my numbers right, that we have increased our net exposure some 50 percent in the last couple of months.

MR. CROSS. Well, we increased it by $10 billion; we had $20 billion and we now have $30 billion.

MR. HOSKINS. That's about 50 percent. So the question is: Do we have any practical limits to the exposure that we want to take on in terms of U.S. economic policy? Since the warehousing arrangement can be expanded indefinitely--

CHAIRMAN GREENSPAN. Implicitly, there are two questions involved in this. They are basically separate ones. One is: Do we have any limits on the amount of those transactions and eventually the net positions we take strictly for the purpose of influencing the market? And two is: Are we aware or do we care about the capital gains and losses that are implicit in that particular action? To date, the amounts of monies involved have been rather modest. One of the problems that you have, no matter what level you're dealing with, is that it's not always the case that maximizing one's capital gain in intervention would involve the same set of tactics that one would employ to influence the market in a certain way. So, those can be two separate basic issues. I don't remember those issues ever coming up or [our positions] ever being of the size where those issues arose. But I would be more inclined to ask Sam whether he knows of any case back in history when there was a concern about the size of our positions.

MR. CROSS. Well, no. I certainly don't recall any such time. We have always had [some] and, indeed, even though $30 billion is higher than what we've had in the past I suspect the time may come when we will be pleased to have some currencies. But--

CHAIRMAN GREENSPAN. Sam, what's the market value of our gold stock?

MR. CROSS. Let's see.

MR. TRUMAN. It's about 9 times the $11 billion; so, about $90 billion.

MR. CROSS. It's $90 billion if you use market price.

CHAIRMAN GREENSPAN. In that sense the same issue as on the foreign currencies is involved--

MR. ANGELL. Very similar.

CHAIRMAN GREENSPAN. One should consider them the same if we raise the issue about an absolute level of foreign currencies. The same logic requires that we question the size of [both].

MR. TRUMAN. Oh, but that--

MR. HOSKINS. I see that differently. I see we are not intervening in gold and in my view muddying up the water; we are intervening in currencies. I'm just wondering: How much would we do?

CHAIRMAN GREENSPAN. What I'm trying to get at is--you're not raising the question on capital gains?

MR. HOSKINS. No, I'm not.

MR. JOHNSON. So, you're talking about whether there is a limit as to how much sterilized intervention we would do as a matter of policy.

MR. HOSKINS. How much are we willing to do?

MR. JOHNSON. But that question, it seems to me, involves our relationship with the Treasury as agent and whether we could do anything we wanted to. That's a big legal question and it gets into all kinds of issues; I've asked those questions before too. It's not very clear.

MR. CROSS. It's not clear.

MR. HOSKINS. But is there some limit where we will be concerned about it? If we doubled [our exposure] to $60 billion, would that call for being semi-concerned?

CHAIRMAN GREENSPAN. If we get up to $60 billion the discussion will last twice as long here!

MR. TRUMAN. Mr. Chairman, it is fair to say--and maybe this is a flimsy excuse, President Hoskins--that the reason there is a limit in the Authorization is precisely for the concerns that you are raising. I think you realize you're asking for a systematic rather than a routine basis. Historically, the limit was in there because we were concerned about the other side; we were building up exposures historically because we were drawing down--

MR. CROSS. Right.

MR. TRUMAN. We were running into debt in periods when it wasn't clear how we were going to bail ourselves out of this process. But it was put into the Authorization--and that was a conscious move on the part of the FOMC at the time--asymmetrically because the exposure was to find out whether we were net long or net short. And it was intended so that the Committee could be concerned about these things. Now, on the Chairman's second question, we have done a staff analysis in a research paper here that was issued recently which does suggest that, at least on the financial risk side of things, our intervention has been profitable. I agree with the Chairman; I don't think that's the major issue here. But that is one of the concerns.

MR. JOHNSON. I don't think that was what Lee was saying. He's saying, as a matter of policy, is sterilized intervention something that you want to do and are there limits to that? I don't think he's talking about capital gains.

MR. HOSKINS. No, I'm not talking about capital gains.

CHAIRMAN GREENSPAN. I think that Lee went into this [issue of] volume. I've never really focused on what the limits are but I think it has been the consensus that we're looking at a dollar bubble that is going to turn down and make the issue moot at some point. If that turns out to be false, I think we had better get involved in a good deal more strategic [discussion] of this with respect to the

Treasury, because I think we all feel uncomfortable about this. But at the moment I would say that the issue is probably unnecessary and will eventually disappear from [unintelligible] forecast on what exchange rates are materializing in this group.

MR. JOHNSON. Still, the interesting question would be, just hypothetically, if we stated that the Federal Reserve would no longer do any intervention for [unintelligible] what would that mean? I'm not sure it would make any difference.

CHAIRMAN GREENSPAN. It would make no difference.

MR. JOHNSON. That's the problem.

MR. CROSS. It might not make any difference; it would depend on what the Treasury's attitude was and what they were able to do about it in part. And that creates all kinds of--

CHAIRMAN GREENSPAN. I think it will be for their own account presumably to get authorization to hold unlimited amounts of foreign currencies.

MR. CROSS. Well, or to make some other changes.

MR. TRUMAN. The worst of all possible worlds would be to give the Treasury the authority to dictate to the Federal Reserve to do it for its own account. Then the Federal Reserve would have no influence over the amount of sterilized intervention that took place. Only the monetary policy operations will offset it.

MR. ANGELL. And certainly we don't want to do that.

MR. TRUMAN. And the next step would be not to use monetary policy operations to offset it.

MR. ANGELL. Of course, Mr. Chairman, my comments had nothing to do with any displeasure whatsoever in regard to the size of the intervention. Even though I'm willing to talk about Mr. Hoskins' point, I fully support our objectives in the sense that I support them as a part of the market stabilization effort as distinguished from a market disruptive effort.

CHAIRMAN GREENSPAN. Are there any further questions for Mr. Cross? We need a motion to ratify the transactions since the May meeting.

MR. KELLEY. Moved.

MR. JOHNSON. Seconded.

CHAIRMAN GREENSPAN. Are there any objections? If not, the motion is passed. Joan Lovett could you bring us up to date on the actions of the Desk?

MS. LOVETT. Thank you. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Joan Lovett? If there are no questions, do I have a motion first to ratify her request for a temporary increase from $6 to $8 billion in the intermeeting leeway?

SPEAKER(?). So moved.

MS. SEGER. Second.

CHAIRMAN GREENSPAN. Any objections? If not, we also need a motion to ratify the actions of the Desk since the May meeting.

MR. MELZER. So move.

MS. SEGER. Second.

CHAIRMAN GREENSPAN. Without objection. The next item on the agenda is our usual chart show. Messrs. Prell and Truman.

MR. PRELL. Thank you, Mr. Chairman. Everyone should have found by his seat a copy of this package of charts entitled "Material for Staff Presentation." [Statement--see Appendix.]

MR. TRUMAN. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for our colleagues? Manley.

MR. JOHNSON. I'd like to follow up with a question I keep asking every time. The interest rate assumptions behind this forecast are generally for higher interest rates into 1990--both short and long rates, but more on the short than the long. Still, if you go back to the February FOMC meeting, I think there was an assumption of a pickup in long rates of up to 1 percentage point from about the 9 percent level then prevailing and of about 1-1/2 percentage points on the funds rate. Since that time interest rates appear to have peaked; long rates are down about 75 basis points from where they were then, instead of up. Short rates appear to be peaking out well short of that range. If the economy has slowed more than anticipated--although I'd have to go back and check that--and if the inflation forecast is maybe even a little lower than anticipated back at that point, what has changed? How do you explain that?

MR. PRELL. In terms of precisely what we were projecting back in February, we did indeed have a rise in short-term rates. We had the federal funds rate moving up to 10-1/2 percent or so. I must say, actually, that the federal funds rate rose more in the first half of the year than we anticipated. At the same time, we had bond yields moving up and approaching 10 percent and on long Treasuries we had some slight movement upward to around 9-1/4 percent in the second quarter of the year. We flirted with that [level]. Clearly, with the recent drop, they dropped below the trajectory we had at that time. We also were not anticipating a dollar on the path that we have seen. My suspicion is that that's an important element in this whole story. Now, we could probably go on for hours trying to dissect what has happened and determine which way causation ran. I personally find appealing the notion that we may have had an autonomous increase in demand for dollars which expressed itself to some degree in depressing bond yields. Be that as it may, the dollar has been on a different path. And as I suggested, we think that has been a significant element in damping inflationary pressures even though there are some lags in the process, looking at the composition of price movements and so on. We think there is something to be said for the argument we presented in the Greenbook dissecting the price measures. On the demand side, I think we have had a surprise on consumer spending. To an extent we were looking earlier at that pattern of household net worth and discounting it a bit. We could see that there was an argument for a higher saving rate. Maybe that indeed is what has happened. We wouldn't have anticipated the stock market being as strong as it is now but the level, as was already suggested, may be driving [unintelligible] and be a drag on consumption. Where we come out now is that we are looking at short-term rates and long-term rates that will be below our expectations. And we think the dollar's higher level will be something of a drag on domestic production growth over the next few quarters and, therefore, something of a depressant on price inflation. We are interpreting this recent decline as having a significant real element, which will help to boost the interest-sensitive sectors of the economy in the months ahead, particularly housing.

MR. JOHNSON. On that point: interest rates on the long-end have been trending down for a while, yet the economy hasn't shown any signs of being stimulated by that.

MR. PRELL. I don't see a declining trend in long-term rates, really. I think they fluctuated in the 9 to 9-1/4 percent range for quite a while and then we had a very sharp drop. I don't think we've had enough time to see the response [to that].

MR. JOHNSON. Well, I think there's--

MR. PRELL. I will admit that the anecdotal evidence does not suggest a tremendous change in the mortgage market and housing demand at this point--or I should say on the home building side. Clearly, there is evidence of a flurry of refinancing activity. And maybe if people are rushing out to refinance they also perceive rates to be more attractive for buying homes. There is naturally a lag in this process and sometimes a tendency to hold back until one thinks rates have gotten as low as they are going to go. So, we would expect to see homebuilding improving in the next couple of months.

MR. JOHNSON. Okay. But I think there is some modest downward trend in long rates; if you draw a line through the fluctuations, I think you can see that. The other point, though, is that rates are considerably lower relative to where you were forecasting them and yet you have weaker GNP.

MR. PRELL. I think it's partly because we have had the weaker GNP. I think the markets were surprised, in part, by how quickly the deceleration in the economy occurred. They became less concerned about an inflationary overshoot and I think that has been a factor; that probably has contributed to some diminution in the inflation premium. At the same time, we think that the real rates will come down.

MR. JOHNSON. That's fine. But why haven't those relatively low interest rates had some stimulative effect, with a lag? They have been lower than you forecast for a considerable period of time. I assume what you're saying is that the dollar has offset that.

MR. TRUMAN. One way to think about it, Governor Johnson, is that the change of the dollar's forecast--at least over the four quarters of 1989 as now projected--is 12 percent. If you think that somehow the market has changed its assumption by that much, that's considerable; they don't have to even see that. They can see future implications, for both inflation directly and for aggregate demand, that are going to come from a stronger dollar over that period--especially if you go back near the turn of the year, or November-December, when we were still dealing with a situation in which the dollar was quite soggy. And to the extent that the market at that time was projecting, as we were, a continued decline in the dollar--which under the conditions of relatively full employment we were going to have to accommodate, if you want to put it that way, by restraining other elements of demand--that was the strength that was then in the system. The dollar turned around and added to that whole process restraint that wasn't in our forecast; but in some sense, it certainly wasn't in the markets' forecast either. So, you have this key change in expectations, which had [effects on the] performance of the economy and on the outlook.

MR. JOHNSON. So going forward, assuming the dollar is not going to appreciate--you even have some depreciation--are you saying, then, that that represents a decline in real interest rates and some stimulus to the economy?

MR. PRELL. If you look at our housing forecast, particularly this time versus last time, you see a different tilt. To that extent there is some stimulus coming to domestic demand. Since our last forecast, the major change, in a sense, has been that we now have the dollar doing some of the work we formerly thought that interest rates were going to have to do. We've had a shift toward a lower net export contribution to GNP growth than we had previously, which is offset by some contribution from interest-sensitive domestic demand sectors.

MR. JOHNSON. Okay, I'm having a little trouble assuming--

MR. PRELL. This may be evaporating by the minute. Logically, if we're going to go incrementally from forecast to forecast that pushes one back in the other direction. But I don't want to make that much of a small movement. The level adjustment has been considerable in the picture--

MR. JOHNSON. I think I understand your logic.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. My question has to do with interest rates as well. The financial projections indicate that interest rates will have changed little through 1990. Then in the Bluebook, there's reference to what the impact might be on other short-term and long-term rates. I assume the projection is with regard to the funds rate. If you had the funds rate in particular remaining at its current level for a couple of quarters, it seems to me that the impact on other short-term interest rates would be quite marked as opposed to the 1/4 point change referred to in the Bluebook--which is over a shorter period I'm sure--and that there could conceivably even be some significant change in long-term rates as well. Is that in the model or in your forecast? I really can't tell.

MR. PRELL. In our forecast there is some backup, for example, in 3-month bill rates and Treasury bond rates but--

MR. PARRY. Could you tell me how much?

MR. PRELL. Well, I've written down about 1/4 of a point this quarter. It's not as large as I think you're alluding to.

MR. PARRY. But if you just let the model run for three quarters how much backup do you think you'd get?

MR. PRELL. Well, I'm not sure I want to let models run on this because, basically, what really has happened, according to our models, is that long-term rates are now where they should be relative to short-term rates given a term structure equation that has its long-term rates determined with a lag by short-term rates. The mystery earlier had been why long-term rates were so high given that we had had the sharp descent of short-term rates. That should have fed through. I don't know that the models capture the forward looking expectations formation that seems to characterize financial market behavior today. I do concede the point that there would be a risk of a bigger backup on this. I was disinclined to be any fancier about this, having made the mistakes in the past that Governor Johnson was so kind to point out again.

MR. JOHNSON. I just had to, Mike!

CHAIRMAN GREENSPAN. If I had asked about this I would have said: Explain to me why your models worked so well so consistently prior to this. This is more like the average [experience].

MR. PRELL. The term structure equation has worked remarkably well over--

CHAIRMAN GREENSPAN. There is a sense in which the problem is that we were getting [inured] to the outcome replicating the models in a way which we cannot expect them to continue to do. What we're looking at to be explained now is a more average experience than what was to be explained six months ago.

MR. PARRY. Well, that's just with short-term rates. The relationship between short-term [and long-term] rates is not more traditional.

MR. PRELL. Well, I think the market is expecting further easing in the funds rate; there's no doubt about it.

MR. PARRY. Okay. All I'm trying to do is figure out the consequences--

MR. PRELL. Indeed.

MR. PARRY. --if you get this level. It seems to me that in the short-term end of the market you'd have a backup of substantial proportions.

MR. KOHN. I think the market probably has about a 50 basis point decline, and maybe more after today--

MR. JOHNSON. I'd say much more after today.

MR. KOHN. --built into the funds rate over the next 3 months or so. So the question is what their expectations would be if we didn't ease. Would they continue to expect that ease down the pike? And that's not--

MR. PRELL. That's what Don has argued in the Bluebook: that because that movement in interest rates isn't going to affect the path of economic activity in the next couple of months that path of economic activity is likely to look soft enough that people will probably still be expecting some further ease--unless they take the view that the Fed is really bent on fighting inflation and taking sizable risks on a soft economy, in which case the bond rate rise, if any, might be negligible. So, I think you get into a very complicated kind of guesswork about expectations against various events in the economic news.

MR. PARRY. But you were saying that the funds rate assumption is what?

MR. KOHN. I think the market has built in about a half point [decline] over the next 3 months or so. Joan [Lovett] has a different view. The bill rates are way down today; they may be a little more after today. But as of, say, Friday or Monday I think that was a fair statement.

MR. JOHNSON. But all that's within a month.

MR. KOHN. No, no. The way I look at it there's [a decline of] about 25 basis points within a month and the other 25 basis points in another month or so.

MR. JOHNSON. The one-month forward funds rate is closing in on what?

MR. KOHN. I don't have the most recent table with me but a few days ago it was about 9-1/4 percent.

MR. JOHNSON. Okay.

MR. KEEHN. For those of us who were on planes today, has something been going on in the market today that is significant?

MR. KOHN. Well, bill rates are down about 15 or 20 basis points--or the 3-month bill rate is, anyhow.

MR. PARRY. And the dollar?

MR. TRUMAN. The dollar has dropped by 2 percent or so since yesterday.

MR. CROSS. It's 1.8815 in marks and 138.30 in yen.

MR. BLACK. Are they attributing that to what they think we're about to do? What is the explanation?

MR. JOHNSON. If you look at the bill market they are.

MR. CROSS. That's certainly part of the explanation.

MR. TRUMAN. That, interacting with the economy and Friday's reports, right?

MR. CROSS. They've been looking at purchasing managers' [reports]. I think there has been a cessation of the things that were driving the dollar up--all these political factors, these portfolio things, that have happened. They have tended to focus on other subjects. They have seen some evidence that the economy appears to be easing, or is at least slowing down a little; and building on these expectations about what's happening to interest rates is certainly part of it, I think.

MR. PRELL. At the risk of beating this too far into the ground I would just say, given our uncertainties, that if the 3-month bill rate were to go up to 8-1/2 percent or a shade higher versus what we have here we wouldn't regard that difference as all that material for the economic outlook. I don't want to hinge everything on a quarter point or so on the 3-month bill rate.

SPEAKER(?). Makes sense.

CHAIRMAN GREENSPAN. Any other questions for our colleagues?

MR. SYRON. Mike, do you have any inkling as to what's going to happen with the GNP revisions?

MR. PRELL. We really don't have much to go on. Perhaps Dave [Stockton could address that].

MR. STOCKTON. The data that we've seen to date--the retail sales and inventory data--are not suggesting a large revision in GNP. But what we haven't seen is so much larger than what we have that it probably would be dangerous to make any firm statement at this time.

MR. BLACK. Any guess on the unemployment rate and the figures this Friday?

MR. PRELL. Our guess at this point is that the unemployment rate will edge up and that we'll have an employment increase of less than 200,000.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Yes, I want to express appreciation to both Mike and Ted for the chart show. Whether anyone agrees or not, I thought it showed very well the total package of what you're expecting. It was particularly helpful to me to have those alternatives that both of you presented. I found it very helpful.

CHAIRMAN GREENSPAN. Any further questions?

MR. GUFFEY. This question may already have been answered, Mr. Chairman, but regarding the notation in the Bluebook that, given the baseline forecast, you might expect short-term interest rates to tick back up because of overplay by the markets: Is the baseline forecast still consistent with, say, Bluebook alternative B?

SPEAKER(?). [Yes.]

MR. GUFFEY. It is. And that contemplates an uptick some time in the future, and probably the near-term future, of short-term interest rates?

MR. KOHN. Well, as we were saying to President Parry, a small uptick.

MR. GUFFEY. A quarter or two up?

MR. KOHN. Yes, a quarter.

MR. PRELL. This is a quarterly-average number that we have in our forecast. One could even reconcile a bigger movement in the near term of some easing.

MR. GUFFEY. Thank you very much.

CHAIRMAN GREENSPAN. Further questions? If not, would somebody like to start the Committee's discussion? President Parry?

MR. PARRY. All right, fine. Mr. Chairman, the economy in the West currently is rather surprisingly robust. Although recent monthly employment data for California suggest that the rate of growth is slowing, the California economy will remain at a strong level. Employment growth in Nevada, Washington, and Oregon ranks them among the six fastest growing states in the nation. Outside of Alaska and Arizona real estate markets continue strong. In April, the statewide median home price in California rose above $200,000 for the first time. Home prices also are rising rapidly in Washington and Oregon, but from far lower levels. One curious development comes out of our regular survey of District business leaders. Almost all of those surveyed indicated that they believe that the economy, in general, is slowing and will continue to slow. But when we ask them about their own businesses virtually no one sees any significant slowing in their own businesses, outside the lumber industry.

Despite the high level of activity on the West Coast our outlook for the national economy is really quite similar to that of the Greenbook. We believe the economy appears headed for sluggish economic growth but no recession. In fact, we see the possibility of some downside risks for the economy in terms of economic growth. According to our analysis consumption and business-fixed investment have been growing unusually rapidly in the past two years. A reversal of this pattern could mean a weaker economy than now seems likely. Despite slower economic growth the economy remains above its full employment level. Thus, I would agree with the Greenbook's inflation outlook, which shows relatively constant rates of inflation for 1990. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I'd say that in the Mid-Atlantic part of the Third District there's a clear change in the tone of the economy. Almost all sectors are flat to down: residential and nonresidential construction are off significantly; manufacturing is flat; retail sales, while up a touch in dollar terms, are clearly down in volume terms; and for the first time since the expansion began employment, as measured by payrolls, is down a little. Having said that, labor markets still remain tight and the unemployment rate is still below that of the nation. Nonetheless, this is the first time we've seen payrolls down. I would say that attitudes in the business community can be characterized as cautiously optimistic, but I do sense a fragility there. I think that the expansion has gone on for so long that people have gotten in the habit of thinking it will continue. Maybe they believe that that is the most likely outcome. But I think we could see a fairly prompt deterioration in those sentiments, at least as expressed by business people in my District.

Looking at the national economy we can't help but be influenced by the people who surround us, and I think the outlook nationally is still most likely to be a soft landing. But the chances of a bumpier landing have increased. As far as the Greenbook forecast goes, I think that the downside risk is greater than the upside risk. There is just very widespread softness in the economic indicators. While there is no evidence of a cumulative downturn, when you see widespread softness you begin to ask questions about whether it might be self reinforcing. So, I would say that, yes, the Greenbook outlook is a reasonable one; but my own sense is that the risks on the down side have increased noticeably over the last six weeks.

CHAIRMAN GREENSPAN. May I ask both you and President Parry whether you sense or know of any marginal inventory backup?

MR. BOEHNE. No, I have not sensed that.

MR. PARRY. No.

CHAIRMAN GREENSPAN. The reason I raise the issue is--

MR. BOEHNE. Maybe a little in retailing outside autos, but not much.

CHAIRMAN GREENSPAN. In the autos you can see it. But there's just the earliest margin that one senses and I'm curious to know whether or not we pick it up from the data ever so slightly in a couple of other places. I want to know whether or not one senses that as being real, cumulative, or an illusion.

MR. BOEHNE. Well, I sense the beginnings of a little hesitation in some planned expansions or equipment purchases. Plans are still going forward but you get just a bit of a feeling that people are beginning to wonder for the first time in a long time whether it is the right decision.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, like much of the rest of the nation, economic activity in the Sixth District has continued to slow somewhat--although I'm getting the sense from people that they don't feel that this slowing is going to continue or, to put it another way, that the deceleration is worsening. The slowing in overall activity basically reflects the balance of very weak construction activity and rather strong growth in international trade. We've seen this translated into rather robust port activity, for example, in the District. As I mentioned last time, it's interesting to note that a lot of this increase in exports and the resultant port activity increases are due to some increase in exports to Latin America. We see the usual continuing sluggishness in housing and auto sales. But this time we took an extra special look at wages and the availability of labor and we still see very little wage pressure, even though in some areas and in some selected industries there is a tight labor market. But wage increases have been remarkably slight. On the inventory question that you raised we don't see much evidence of inventory accumulation in the District--outside of autos, of course. The general tone perhaps coincides with what others have said in that there now seems to be a shift toward some concern about too rapid a deceleration, whereas before in the District people were saying that inflation was a concern. Although I don't think it ever was an acute concern there was more concern about that than about a decline in the economy. I think that has very definitely shifted. And while people will tell you that their own businesses are doing fairly well, there is a cautionary element now that is going to be reflected in business plans in our District at least.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, our projections are very close to those in the Greenbook. We have slightly higher growth in real GNP and a slightly higher inflation rate but the differences here are really minor and not worth mentioning. The overall profile of the forecast is just about the same. More interesting than the projections themselves is the question as to where the risk of error probably lies. If one looks at domestic final demand only, one might conclude that the risk in the case of GNP is definitely on the down side. But, as we all know, the behavior of net exports of goods and services has had a very large impact on our total GNP over the last six years. And the prospects for net exports are something of a wild card in the outlook currently. I think the staff's projected sharp drop in the growth of exports is certainly reasonable, given the strength of the dollar. But the underlying demand abroad is pretty strong in a number of countries and this could buttress our exports for a while, I think, even if the dollar remains relatively strong. On balance, I would say that the risk of error in our forecast and that of the staff's is probably on the down side; but I wouldn't rule out the possibility that the economy could be a little stronger, given this wild card on the export side.

When we get to the price issue, I think the risk is about evenly distributed. The staff is expecting that the underlying rate of inflation as measured by the CPI less energy and food will be about 5 percent over the next several quarters. I think a lot of that is going to depend on how strongly these aggregates come back and whether the projection of growth in the aggregates is really going to materialize. On an anecdotal level, at a recent meeting of our board of directors to which we invited our alumni there were more mentions on the part of both groups about how tight labor really is and the virtual impossibility of attracting labor. Now, we have a pretty prosperous District by and large with the exception of a few parts of West Virginia. But still, it was striking that so many were reporting such difficulty in attracting labor. This leads me to think that we may have more wage/price pressures than some people assume or that these pressures may be around a little longer than some are assuming.

MR. FORRESTAL. Excuse me, Mr. Chairman, could I back up? I neglected to mention our forecast and outlook for the national economy. Our forecast for real GNP is somewhat stronger than the Greenbook's and our forecast for inflation is higher as well. The difference in GNP is almost entirely due to our view of consumer spending; and I gather from what the staff said that perhaps they are a little uneasy about that forecast. We think consumer spending is going to be somewhat higher. If the Greenbook is correct about consumer spending I suspect our forecast would be about the same as theirs.

CHAIRMAN GREENSPAN. Okay. President Keehn.

MR. KEEHN. Mr. Chairman, with regard to the current situation, at least in a national context, I do think there is a buildup of indicators that suggest fairly specifically that the growth rate is moderating. That's particularly true in the interest-sensitive parts of the economy, notably cars and residential construction. But across a broader spectrum of the current leading indicators I think we do see some tendency for moderation and a trending downward. With regard to the forecast, ours is really very similar to the Board staff's. We have somewhat stronger growth in 1989 and more so in 1990. I doubt it's worth going down sector-by-sector because I think in the main it's a difference in the policy assumption that we use in putting our forecast together. We would expect a more rapid decline in interest rates, particularly short-term rates, than is true of the staff forecast, which accounts for our higher outlook on GNP growth.

With regard to the District, what seems to be true in the national level is certainly less true within the District. There are a couple of parts of the District that certainly have peaked and are heading down. Automotive is clearly a part of that, and merchandise sales have been trending down for the last couple of months. But other parts of the District continue to show strength. For example, through May commercial construction contracts were up 1 percent versus a decline for the United States as a whole. That same kind of dichotomy is true for residential construction. We've had a bit of an increase whereas other parts of the country have been down. As a result of that, within the District the demand for building products, specifically gypsum and cement, has been pretty strong. And the demand for business equipment and other categories of industrial equipment continues to be surprisingly vigorous. The steel business has been good though they expect something of a decline in the second half. Nonetheless, the first half has been good enough that for the year as a whole steel in the District will come in pretty well. Employment in the District has shown good gains. We are equal with the national numbers and at this point our unemployment rate for the

District as a whole is under the national average; that's the first time that has happened in a while.

On the price and inflation side the situation is a bit more mixed but I think, on balance, it's positive. The reports we're getting from our directors as well as other market contacts would suggest some stabilization in raw material prices. Indeed, a couple are coming down; aluminum and copper have been mentioned as prices that are coming down. And with some minor exceptions there are no stand-outs in the raw material category that are showing great big increases. For finished product prices I understand that market pressures continue very intense. For example, in the paper industry they're operating at higher rates. who runs a company in one part of that industry says they are operating at 93 percent. And though they have had price increases over the last 12 months, looking ahead they think they are not going to get any increases at all. And that's quite unusual to be operating at those higher rates and not getting price increases. On the labor side, despite very tight conditions I'm surprised and impressed by how good at least the organized contracts are coming in. People are still getting 3-year contracts and some are quite low. I heard one comment of an increase in costs of 1-1/2 percent per year but that's unusual. The 3 percent continues to be quite common. On the agricultural side, and here I think the situation is very uncertain, the eastern part of the dDstrict has had far too much rain and the western part has not had enough; unfortunately, you can't average that out. We're simply going to have to wait and see how the growing season takes place to determine whether or not we're going to have good yields. But despite that, the demand for agricultural equipment continues to be surprisingly strong. Both tractors and combines are being sold at a higher rate this year than last year. One of the major manufacturers in our District has cancelled a two-week summer shutdown so they can keep up with demand. I think the District doesn't quite reflect the trends we're seeing in terms of the national numbers. But having said that, we lagged the recovery on the way up; and I think it's probably true that we're going to lag this turn on the way down. Pretty shortly some of the moderation trends that we're seeing nationally will show up in the District as well.

CHAIRMAN GREENSPAN. Thank you. Governor Johnson.

MR. JOHNSON. I'm getting a little more concerned about the economic situation since we met last time. Starting on the same day that we made our modest change in borrowing, June 5th, we got a whole series of data that I think have become a little more troubling. On June 5th auto sales came out and were marked down from May over the previous April by about 2/10ths of a million units. Today when we get the report for June I think the numbers will be down again. And auto production schedules have been cut back some since that time. On June 13th we got reports on real retail sales, which were down 7/10ths of a percent; and that was the fourth month in a row of negative real sales. On June 15th industrial production came out and had increased 0 percent. Capacity utilization was marked down. On June 16th we got housing starts, which were down for May by about 2.1 percent. And permits stayed unchanged at a fairly low level. On the 23rd of June we got new orders for durable goods, which were down 4-1/2 percent for May; nondefense capital goods orders were down 8.6 percent for May, and excluding aircraft they were down about 3.2 percent. Real personal consumption, which came out the same day, was down 0.3 percent, and real personal income was down 0.2 percent. On June 28th we got leading indicators, which were down 1.2 percent; they were down in three out of the last four months. Then, most recently, we got the purchasing managers' survey, which showed new orders for June actually negative for the first time in a long time. Vendor performance for June for the first time in a long, long time showed actual faster deliveries, not just a slowing in the rate of increase [of backlogs]. Prices paid were also down below the 0 line, showing an actual decline for the first time. That's a whole string of data. And that's starting to look like a deterioration.

These data are all just series of information that are incorporated in the financial markets even more. We have seen it build up over the last several weeks. The yield curve has gotten more negative. Bond rates now are down quite sharply; they closed in on the 8 percent rate for a while and for the 30-year bond they're still around 8.12 percent, or something like that. If you put the fed funds rate on a coupon basis, the yield curve is inverted by almost 2 full percentage points. The markets are clearly expecting lower future rates by a considerable amount. The bill market has even started to discount more sizable moves than I would imagine. Now, maybe it's just a lot of noise lately, but the bill market is down 20 basis points today. Looking at the traditional relationship between rates on bills and fed funds, which builds in a spread of about 3/4 of a point, if you take into account where bills are today the market is discounting almost a full percentage point decline in the funds rate. There may be some noise in there, for sure. But the fact is there's a fairly sizable discounting going on in the markets, based on a string of data like this and a lot of information that's coming through. What worries me about it is that once that psychology starts developing--and the longer the short end of the market is held up--the more future interest rate declines are anticipated. Once you get that psychology in the market investors start postponing investment projects expecting rates to go even lower. Consumers quit financing consumption because they expect to finance consumption at an even lower rate in the future. And this situation starts feeding on itself. The postponement of activity due to expected future declines in rates will continue as long as the short end of the market is being shored up so high above the long end. I think that's one of the risks. Now, if nothing happens what worries me is that markets could become disorderly at some point. A string of data like this and a feeling that the market is not realigning itself on the short end with expectations on the long end at some point could make the stock market vulnerable to flight. That's what I worry about. Whether this will continue is not clear. But I see a very troubling series of trends going on.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Mr. Chairman, the New England District that has led the upturn to some extent is certainly way out front in the downturn. In talking to our directors and other people around the District, I'd say in terms of making their own investment decisions and going forward there is some cautious pessimism on their part. Things seem to be fairly soft over a pretty widespread area. Specific industries such as the high-tech and computer industries are quite soft. Some of that may be related to particular mix factors in that part of the industry. In the defense sector, which is very important, current work in process is starting to be reduced and they are really concerned going out. Employment has been growing somewhat more slowly than nationally for a while now. Superimposed on all of this, we do have an overhang in the construction industry and in the housing industry; the result of this is that loan demand has softened a bit and we're starting to get a backlog of property on the market and an expansion of auctions. This combines with the fact that we have in Massachusetts, the largest state in the District, very serious fiscal problems--both state and local. People reading about the fiscal problems continuously has led to a broader pessimism, which has been reflected in retail sales. So, inventories are not a problem at this point in time but people are being really quite cautious. Wages have been well behaved, as you might expect in this environment, though the labor market in the services area--particularly the lower-end services sector--is still quite tight. But it's loosening up a fair bit in production levels.

As far as the national economy goes, we would generally agree with the Greenbook as it was presented with a couple of caveats. We have somewhat stronger growth in GNP as a result of somewhat stronger consumption growth--obviously in other parts of the country--with the saving rate not holding up as high as the Greenbook has it. We have some concern about higher inflation because of the uncertainty on our part that wages nationally will remain as well behaved as they have in the past, particularly looking at the tightness in labor markets and what has happened to prices in an overall sense--not just excluding food and energy, but all prices. So, I think it's pretty clear that we're in a very difficult period. We don't see a cumulating downturn in the economy. But I think the risks are at least balanced, with probably some more margin on the softer side of the economy.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. On the regional side, the Tenth District is continuing to improve. To be sure, it's still lagging the national scene; but given where we started a couple of years ago we're still improving. On the food and agricultural side the outlook is good, notwithstanding all the talk of what has happened in the drought areas. For example, drought has [hit] in Kansas and the northern sector of Missouri and it extends up pretty much across Iowa. But given the additional acreage that has been planted, the outlook for production of agricultural products is really very good in light of the rain that has fallen in a good part of the United States outside of the Tenth District. In wheat specifically, the hard red winter wheat that is principally grown in the Tenth District--in Kansas particularly and in Oklahoma and Texas--that crop to be sure is going to be down considerably because of the drought situation. But overall, it's important to note that the production of wheat on the national level is going to be up about 15 percent above what it was last year. And that's notwithstanding the fact that Kansas, which is one of the biggest producers of the hard red winter wheat, is going to harvest something less than half of the crop harvested just a year ago. Given that kind of an outlook, we would agree with the comments that were made by Mike and others with respect to food prices in the period ahead: that they will be moderate, with about a 4 percent increase over the next year. The energy industry in the Tenth District has not fully participated in the nationwide improvement in exploration and development. Indeed, in Oklahoma the number of rigs fell substantially over June, for example, whereas nationally that count was up. Manufacturing continues to improve, largely in the export-sensitive aircraft and high-tech areas. And construction continues to improve very modestly in the District. It is above the year-ago level; although commercial construction is down somewhat, overall construction is up.

On the national level, I recognize that in all of the numbers that have come in, and that have just been recited for our review, there is a softness that appears to be showing through. I would see that as coming close to achieving the objective that we've been striving for, and that is, to bring the overall growth down. However, we would see growth in 1989 and into 1990 somewhat greater than the Greenbook forecast, largely reflecting a bit stronger consumption than the Greenbook forecast incorporates. Overall, the only real evidence of wage [pressures] and concerns that we have been able to uncover in the Tenth District is in the steel settlement that was announced earlier. There's a real concern that a steel producer in the Tenth District who is in the midst of negotiations now will be badly hurt if that type of settlement is imposed upon them. That's all I have, Mr. Chairman.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. In terms of the outlook, our money-driven model ends up with a pattern very similar to the Board staff's forecast--in other words, slowing real growth and inflation leveling off over this year-and-a-half period. The main difference is on the real side where we have considerably weaker real growth--roughly 1-1/2 percent for this year as a whole and 1 percent for next year. But in terms of the deflator our numbers are within a tenth or two of what the Board staff has. The only other thing to mention is that our forecast assumes, as does the Board staff forecast, a reacceleration in money growth in the second half of this year and continuing on in the next year.

As far as the District is concerned, our numbers show this continuing pattern of slowing that has been mentioned. Non-agricultural employment growth is slower than the national average. It's interesting that even though the unemployment rate is coming down the District rate is still somewhat higher, at around 6.2 percent. But the labor force obviously is growing very slowly. Manufacturing employment, in contrast to the national picture, has really held up with other employment growth. We're not seeing the relative weakness that shows up nationally there. However, there are some industries where there is a slowing or, in fact, declines in employment: in the auto industry employment growth is slow; and there have actually been declines in food processing, electrical machinery, and printing and publishing. The one area of notable weakness is nonresidential construction where in the most recent period for which we have data, the 3-month period ending in May, we have a decline of about 20 percent compared to the prior period. Again, I think we have just gone through this cycle quite a bit later than some other parts of the country in terms of the nonresidential construction. As far as [unintelligible], I don't really detect the same shift in tone as some others have mentioned. Certainly, people will acknowledge that there has been a slowing, but in the contacts I've had I have not picked up this concern about possible cumulative weakness.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. As best I can judge, the District economy is now performing very similarly to the national economy. That is, the pace of the expansion in general has slowed--allowing, of course, for the usual diversity between economic sectors and particular regions within the District. As this has happened it seems that earlier concerns and reports about inflationary pressures have ebbed at the same time; and this has gone on even though for the most part labor markets remain quite tight and we continue to hear reports of labor shortages.

With regard to the national economic outlook, our model generates an interest-rate pattern similar to the Greenbook--that is, essentially flat interest rates from here on out--and somewhat more rapid real growth, especially for 1990. I personally am a little more cautious than that, in part from reading and reviewing many of the same statistics we've all looked at and Governor Johnson summarized. But having said that, I would also add that in many respects it seems to me that things have worked out largely as we might have hoped a few months ago, in the sense that I think it was recognized that we needed a slowing in consumer spending and a slowing in the pace of employment gains if we were to arrest what appeared to be building inflationary pressures and some deterioration in the psychology about the price outlook. So, I think in many ways things have evolved about as well as we might have hoped.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, the Eleventh District economy continues to show modest improvement overall. Much as Roger indicated for the Tenth District, we do have to keep in mind that we were coming off a very low growth base of economic activity. Even though we are getting modest improvement we continue to show weakness in construction activity, and I guess that would be expected for us. Single-family housing is the only area of construction that does show some improvement. While the energy sector has shown a little growth in the last few months in response to the higher oil prices, the gains are very small. Drilling and related activity are still below the depressed levels of a year ago. Recent rains have improved the agricultural outlook for this year in some parts of our District. But nonetheless, we still expect farm income to be a little below last year's. We are seeing continuing gains in the manufacturing sector, with nondurable goods showing the greatest strength. The outlook in our area is at best guardedly optimistic as cuts in defense spending, slowing in overall demand nationally, and an inability to expand output in chemicals, petro-chemicals and paper all combine to restrain [the prospects for] growth in coming months. Orders growth has been slowing in several industries. Retail sales, including autos, continue to show year-over-year gains down our way. And Houston continues to be kind of the shining example for us, which is a considerable change over a couple of years ago. Price and wage pressures remain well below the national average in that regard. I am glad to report on the financial side that in the first quarter our District banks just about broke even for the first time in over two years. Nonperforming [loans] and charge-offs continue to move in the right direction; but part of this is a statistical illusion as many of the loans in recapitalized banks are put back to the FDIC. All in all, we think the banking sector is still several quarters away from supporting business expansion. We haven't noticed or detected any real inventory problems in the District. With respect to the national outlook, the Greenbook [forecast presents a reasonable picture of] what we're going to be facing.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mr. Chairman, I'm delighted to see these indicators showing a significant slowdown in the rate of growth. At the same time, I'm skeptical about whether we have seen the full effect of the inflationary pressures that were there in the past. I believe that we are more likely to see at least a quarter more of some upward pressure on prices as the [past pressures] are reflected. But what concerns me most are the consequences of a more severe slowdown that could be triggered by a failure of the expectations that Governor Johnson was touching on a few minutes ago. I think the markets are extremely skittish. The way the stock market, the foreign exchange market, the bond market, and the money markets have been bouncing around makes me nervous because I think that reflects the nervousness of the markets trying to read things into every bit of information that is published and reacting--or overreacting, in my opinion--to things that are not necessarily indicative of what's going on in the big picture.

At the same time, as a backdrop to all of that, I think the financial system is rather narrowly balanced. We have these huge amounts of corporate debt, some of which is based on a very skinny coverage of debt service. We have junk bonds being a significant investment in a number of pension funds. A number of banks are supporting the short-term credits involved here. And we have a lot of S&Ls with a lot of that junk paper as well. So a significant turndown in the economy could cause all that to get out of whack and have a ripple effect throughout the whole financial system that I think could be very severe. A lot of that debt is really based on continued growth at current or immediately past levels rather than on the kind of growth that we're talking about, which I suspect may be a disappointment. We also have an LDC debt situation that is more and more unsettled because of political influences. And the banks, if they are encountering very severe profitability problems in other directions, are going to be in a far less competent position to handle the kinds of pressures that may be imposed either because of the adoption of debt reduction plans or because of simple default. We have a real estate market that is increasingly soft in many parts of the country where it was previously very strong. And that is going to be compounded by the overhang of the RTC disposal situation which is X hundreds of billions of dollars. Whichever strategy the RTC adopts--whether it is a quick disposal and [a decision to] dump the overhang on the market temporarily and hope the market will come back, or whether it's hold onto it--the overhang is going to tend to depress those prices. It seems to me that anything that could restore some confidence in the markets might have a desirable effect there, because the banks and the S&Ls are the principal ones who are going to get hurt by that kind of a situation.

So, I think that in spite of the risk of not achieving further progress on inflation immediately, the effects of a significant recession--if that's what we've tipped into--could be even greater. I'm not at all satisfied that we even have to be in what is technically a recession in order to have significant changes in business plans and significant consequences in the areas that I'm talking about. I think there are great expectations out there for lower rates, and the disappointment of those expectations could result in an acceleration of the slowdown that could take it out of our hands. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Well, for the second month in a row, I can report that [businesses in] the Fourth District are less optimistic than they have been for the last 18 months. Having said that, overall they are still operating at pretty high levels of utilization of resources. Nevertheless, there has been a slowing in the pace of sales, new orders, and even production. We have things that were on allocation that are not on allocation now. We have some, at least, not accelerating factors. Overall, people in the District that we've talked to still expect the inflation rate to stay between 4 and 5 percent and to be relatively stable in that range. Among those who are less optimistic, it will be no surprise to you to discover steel. Their concerns may have evaporated in the last two days because they were primarily based on the idea that the dollar staying where it was would impact them--being a commodity-oriented business more than some of the others; they had concerns that the second half would be impacted by that level of the dollar. Capital goods also are softening, but for different reasons. There are cutbacks in auto demand and cutbacks in defense spending and those are cutting into machinery fairly significantly. But the backlogs that are in place will carry people in terms of production and shipments pretty much through the remainder of the year. There is one other point in the capital goods area: [Unintelligible] continues to say that the export side has been very good, that the foreign investment boom is going to continue. So they are looking for continued strength through the year in terms of capital goods. Inventories overall are not a problem, but people are saying that apparel is starting to back up as are home building and materials a little. But it is nothing that they are overly concerned about at this point in time. They think there will be very quick adjustments before the situation could get out of hand.

CHAIRMAN GREENSPAN. When does the steel contract run out?

SPEAKER(?). August 31st.

MR. HOSKINS. The price?

CHAIRMAN GREENSPAN. No, the contract.

MR. HOSKINS. Wage contract?

CHAIRMAN GREENSPAN. Yes.

MR. HOSKINS. That doesn't occur for USX until 1990, I think. Everybody else is late this year, if I'm not mistaken.

MS. SEGER. National is--

MR. HOSKINS. National has already done theirs.

MR. BOEHNE. Bethlehem is--

MR. HOSKINS. Everybody has started but USX doesn't have to face it, I think, until 1990 or 1991.

CHAIRMAN GREENSPAN. What's the strike-hedge buying that the purchasing managers were talking about this year?

MR. HOSKINS. The strike buying?

CHAIRMAN GREENSPAN. As I recall, the purchasing managers were commenting about strike-hedge buying in steel.

MR. HOSKINS. I'm not sure which--

MR. PRELL. There have been a couple of negotiations and there is one ongoing, which was referred to earlier. Those may have been what they were looking at--Bethlehem and some others.

CHAIRMAN GREENSPAN. Oh no, they weren't referring to Bethlehem or National--well, it may have been National.

MR. STERN. But I thought National rejected the contract.

MR. KEEHN. Inland has been in negotiations but I don't [think] they are a major supplier of the auto companies.

CHAIRMAN GREENSPAN. Yes, it could have been National or Inland that they were commenting on.

MR. PRELL. Actually, I heard those stories some months back as explaining the strength in steel production, even in the latter part of last year. It has been a pretty murky matter as to what was going on and the timing.

MR. HOSKINS. In terms of the national outlook, we don't have a quibble, really, with the Board staff's projection. I'm happy to see that we don't have accelerating inflation and I'm not very happy to see that we don't have decelerating inflation. I am concerned that we think we can do more with demand management than we've proven to be able to do in the past through monetary policy. And I continue to think that our long-term objective ought to be to get some more progress on the inflation rate than we're showing in any of the alternative scenarios.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. Mr. Chairman, I view the staff forecast as basically a reasonable one. My own forecast is probably a bit stronger in real GNP growth terms, as has been the case for a long, long time. We have an inflation rate both this year and next that is still running 1/2 percentage point or more above what is in the staff forecast. I look at the forecast today versus, say, 12 or 6 months ago, and I think there is an important difference in that 12 or 6 months ago I, at least, viewed the situation as being distinctly asymmetric on the side of too much growth and too much accelerating inflation. I would view the staff forecast now as reasonably well balanced. But by definition the forecast that in those circumstances is reasonably well balanced today is one that does have somewhat greater downside risks than it did before. But that's in the nature of things. That to me says that we've either been lucky or good. Now, on the question of lucky or good--

CHAIRMAN GREENSPAN. Or both.

VICE CHAIRMAN CORRIGAN. I was about to say I think where I come out is both. I say that because I am hard pressed to convince myself that the rise in interest rates over the past year or so, going back to March last year, has been decisive in causing the slowdown in spending we have seen, except in housing. In other areas in which we have seen a slowdown I think I can convince myself that the slowdown may have as much, if not more, to do with other things than it does with interest rates. Certainly, I think that's true in autos where saturation alone, coupled with the bunching up of purchases of fleets of automobiles by auto rental agencies and others, is producing some anomalies--as reflected in the widening spread between used car prices and new car prices. In the area of nonresidential construction, I think the slowdown is at least as much, if not more, the result of the excesses that took place earlier, in terms of commercial real estate development and shopping centers and other things. Energy I don't think is interest-rate driven. And the slowdowns that we're seeing in both state and local and in Federal government purchases of goods and services clearly are not interest-rate driven. So, I think there has been a combination of some fortuitous developments, rather than luck, and some good policy that has produced the kind of result that I think many of us wanted to see.

Although I agree with much of what John LaWare said about all these financial problems, the only problem is that I could make a case that they are an argument for tighter monetary policy rather than easier policy. Be that as it may, on the anecdotal side there is clearly a sense that one picks up, as several others have talked about, of things having slowed down further--especially in May and June. As I mentioned to you earlier today, Mr. Chairman, periodically we have been talking to a group of firms--we can't call it a survey because OMB would get mad at us, but it has certain characteristics in that direction--and I'd like to share with the Committee several features that came out of our talks with these firms in the period of June 19th to June 23rd. We have done this enough so that it has its own little history to it and we can get a sense of what the dynamics are. First of all, in terms of export orders and export growth the [unintelligible] pattern now is that most of them are still seeing export orders running in a range of 10 to 15 percent increases, which is down from 20 to 25 percent last year. But that seems to be largely a kind of a saturation thing. None of the firms, with the exception of one small manufacturer, said that the exchange rate appreciation that we've had in recent months has yet had any impact on their export orders, although several did say that if the exchange rate stayed above 2 marks or 140 yen that they would expect that to begin to show. But it has not shown to date. They also are suggesting that their backlogs of export orders are still high and rising. I'm not going to go through all of this but just on the question that you specifically raised, Mr. Chairman, the second interesting part is on the inventory side. What we see is that the clear majority of firms, especially the big firms, are reporting inventories as quite normal. But again, in sharp contrast with earlier discussions with these people, we now have something like a third of them expressing a little uneasiness about inventory developments and a couple saying that inventory developments may well prove to require some production slowdowns. Again, it's not precisely [the information] in and of itself; it is that there is a change in the kinds of things that these same firms had been saying to us in the past. The price forecasts are basically, except for certain sensitive commodity price tables of intermediate materials, in the 5 percent range. Capacity investment plans are holding up; there are no major changes. And in some cases these companies are talking about very major investments. The paper company is talking about two new plants coming on stream in the early '90s, and this is big stuff. There is no sign of any retrenchment at all. There is one interesting development. A large chemical company tells us that they are getting ready to build a new plant that won't come on stream until 1991--Mr. Truman, you'll be interested in this--and they went out and hired to assure them that the dollar would come down before they made their decision.

MR. TRUMAN. Did they get their money back?

VICE CHAIRMAN CORRIGAN. They volunteered that. The last thing that I think is very telling is in their anticipated wage bill increases for 1989. And here, there is an unmistakable virtually across-the-board acceleration. About a third of the firms are now talking 3 to 4 percent; they were talking 2 to 3 percent. Another third are at 5 percent; they were talking more 3 to 4 percent. And another third had increases ranging as high as 10 percent, but most of them were within the 5 or 6 or 7 percent range. What should one make of this? I'm not sure. But clearly, there are three or four areas--export orders, inventories, investment, and wages--where [discussions with] this handful of very representative firms do suggest some important changes from what they were telling us a year or two ago.

There is one last point I would make at this juncture. I want to say a little more on the inflation issue in the context of the policy discussion tomorrow. If I go to Mr. Truman's chart 17, the external side of our economy still stinks; there's no other way to put it. Nobody else seems to worry about it too much, but I sure do. I don't know what the right exchange rate assumption is, heaven knows. But if you take our forecast--this is a minor thing at the margin--we get back in 1990 to a situation in the United States where domestic demand is growing faster than GNP again. It's not by a lot but that's where we end up. That's not a forecast as much as it is an observation. But if you look at those numbers, you can put whatever margin of error you want around them and they are lousy. That net investment position in 1990 ends up at minus 14 percent of GNP. That is trouble looking for a place to happen; and it's going to come home to roost on us sooner or later. And partly for that reason, that reinforces my own view that I'm quite prepared to accept running some risk of the kind of slow growth that is built into the staff forecast and maybe even growth that is a little slower than that.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. In looking at the current situation, it does seem clear that there has been some change of patterns. Of course, a lot of this is very, very good. Those of us who would like to see the trade balance corrected without a depreciating technique would believe that that's the only way that we're going to get to our primary [objective] of stable prices. We're going to have to have a stable dollar to do that. And certainly the slowdown in consumer spending is an integral part of that success. The only problem is whether anyone believes that you can take consumer spending from a 3 or 3-1/2 percent range and cut it in half and somehow or other just automatically stop there; I think there's some uncertainty about that. I don't know whether Mike will be pleased to note that there is at least one individual on the Committee who is on the other side in regard to the consumer spending issue. Mike, I'm looking for decidedly slower real consumer spending than the Greenbook. And I note that I'm the only one, I guess, who is on that side. You've heard a lot of others on the other side. So, it helps to get you closer to the middle, Mike, for me to take that position. The reason that I believe consumer spending was slow in the second quarter and had slowed below what we had in the first quarter and below what I think the Greenbook says for the second quarter relates to a very logical follow-up of a set of developments. One is that we have had extremely slow money growth over such a long period of time that there is not the kind of liquidity out there to support what has turned out to be inflation in the discretionary consumer spending area. If you only have 10 to 15 percent of consumer income that is discretionary spending, you don't have to [unintelligible] to begin to make a decided difference. When we have reports that we not only have the unexpected estimated income taxes in April but we also seem to think the money stock was showing that, then that seems to go along also with some adjustments in terms of consumer behavior. It wasn't so long ago that during April tax paying times it was somewhat more noted as to how much borrowing might be utilized to facilitate the income tax effect rather than some sense of drawing down money balances. Stop and think about marginal tax rate changes and the lack of deductibility of some interest rates, including the lack of deductibility of borrowing money to pay your income taxes; that causes the after tax interest rate to be decidedly higher than it had been before. It seems to me quite logical, then, that you'd get some differences in this kind of environment in personal household saving rates. And that, together with certain maybe overpublicized demographic factors, it seems to me leads us to a different kind of behavior--which of course is exactly what we've been wanting.

So, I don't think we need to grieve too much about getting the exact same results that we were after. We wanted to slow money growth down because we didn't want to revive the liquidity that would be necessary in a sense to accommodate these inflation pressures that I think all of us knew would be forthcoming--given the import price side and the energy price and the other commodity price effects, some of which stemmed from last year's drought. So all in all, it seems to me it's very logical for consumer spending to be low and for it to stay low. Now, when you add to that what's happening to housing, there are enough communities in the United States where the housing market has changed so that the wealth effect of this change in housing must necessarily, it seems to me, show through in regard to spending patterns for consumers. So, I'm bold enough to have consumer spending growth rates only about half of those the staff is projecting. And yet I end up getting, I think to Mike's embarrassment, almost exactly the same real GNP numbers that Mike had.

MR. PRELL. We welcome you.

MR. ANGELL. Oh, you welcome me! Well, [unintelligible] we're both probably wrong, but for different reasons. Nominal GNP, it seems to me, is not going to be able to be as expansionary as has been predicted. I just so believe that the monetary slowdown will show [unintelligible] on nominal GNP. So I tend to be optimistic in that regard; that's why I have [forecast] what I would call a rather nice expansion. But if I'm wrong on that and inflation runs about as Governor LaWare thinks it will, then I don't think there's any room, and I think there are considerably more downside risks. But I'm going to remain somewhat optimistic.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, we continually and, of course, properly discuss the risks and how they vary--from inflation kicking up as a result of too strong an economy versus making progress on inflation as a result of the slowdown. I find myself very much with Governor LaWare; he really made my speech and I certainly won't repeat it. But one word that I think was in his remarks bears some emphasis, and that's the fragility of this situation. However you assess the risks, it seems to me that the fragility on the down side is quite substantial and should be recognized as an element therein. Another thing that I think was in his remarks that I'd like to emphasize is the consequences of which way these risks fall. If we wind up with a somewhat stronger economy than we think, then inflation will probably carry along for a while and it's hard to say exactly how it will behave. But I don't hear anyone saying that there is any risk of inflation running away from us on the up side. On the other hand, I think the consequences of seeing a downside result could be very severe indeed, in terms of the larger social picture of the country and where we are and what we're trying to do in this country. And I think as we assess the risks, however you come out on where the risks are, it's useful to think in terms of the composition of those risks and the consequences of having the risks fall out in either of the two directions that they could go. So I think it's worthwhile to consider those two aspects: fragility, which seems to me to be wholly on the down side; and the consequences of the result that we might realize in either direction, which also seems to me to be far more severe on the down side, should it work out that way.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I've been sitting here thinking that I need a new hearing aid because I can't believe the change in the comments today versus the FOMC meeting in May or, for sure, the one in March. Either I needed the new one then and not now, or vice versa. Anyway, as you know, I've been somewhat concerned about the slowing economy for a fair while. So, it is nice to have some other people who are on board with the same concerns. Where I depart from the staff forecast is over the next six months or so, for a couple of reasons. One is that in the auto industry, I think for the first time in three or four months, we're going to find that the auto manufacturers actually have some latitude to adjust production. As they got into the late stages of this model year they were locked in because they had made commitments to suppliers to take X amount of materials and, therefore, they carried through with their production plans; but now they are reaching the end of that run and we're seeing announcements already of extended shutdowns from model changeovers. And this is sort of the first round. Then Chrysler, for example, when it starts up the new models at one of its plants, instead of putting two shifts on is going to put one shift on. I think we're going to see a number of these things. Instead of just holding production constant and trying to ram the sales through the system through the use of these various incentives--which made the dealers very, very unhappy--I think we're going to see more and more production cuts. I realize that the auto industry is no longer as important a share of the U.S. economy as it used to be, but in terms of explaining cyclical wiggles I think it's still rather significant. Therefore, I think over the next two quarters what's going on there may be really rather significant.

I got some numbers this morning that I'll just share with you because, on the one hand, they were interesting; on the other hand, they were rather scary to me. Chrysler sent some surveys to their dealerships and what they have discovered is that 60 percent of the people coming into their dealerships were not able to come up with even the downpayment to buy a car. That's sort of scraping the bottom of the barrel, as I see it. One reason, of course, is that used car prices have weakened; and [that hurts] those who, when they had trade-ins, could forget the downpayment. I find the [unintelligible] system working; the others don't necessarily have trade-in difficulty but they just don't have the cash on the barrel head. And this includes, by the way, the opportunities to use cash rebates for downpayments; even with that availability, 60 percent weren't able to get a downpayment together. Also, the number of people actually coming into their showrooms is down about 10 percent from a year ago. And what they call the closure rate is down. So, of the people coming in, the number who actually go through and make a purchase is way down--I don't know by what percentage. Also, 31 percent of their dealers are now losing money versus under 20 percent last year. Those that are still profitable, though, have seen their profits drop to less than half of what they were a year ago. Jerry, you mentioned that tight money hasn't had the impact you might expect; I think you can see it in autos. And it works through the dealers, as the dealers have had to pay 3, 3-1/4, or 3-1/2 percentage points more to inventory this tremendous pile of cars; that's real money to them because they are the ones, as John LaWare knows, who have to pay these financing costs. General Motors doesn't, or Ford doesn't. The dealers have seen these financing costs soar and that has increased their unhappiness with the situation; it has also increased the flow of gripes back to the auto manufacturers. By the way, auto sales picked up in April when these incentives went in but since then, even with the most generous incentives in place--to me these are the most generous incentives since they launched incentives back in '86--sales are viewed by people in the industry as disappointing in both May and in the sneak preview of the figures for June that they had received just before I talked to them. That's one thing that concerns me.

The other sector where I'm a little more negative than the staff forecast is in housing; I believe the staff has housing starts hitting bottom this quarter and then starting to percolate up. I would like to think they would turn around that quickly but I'm not really that convinced that they will. Therefore, as I said, my concern is how we are going to make it through the next couple of quarters before we see some of the monetary changes work through, because I think the very slow monetary aggregate growth that we have had is having an impact and, unfortunately, that it is going to continue to have an impact for a while. Thank you very much; I hope we're lucky.

CHAIRMAN GREENSPAN. If there are no further items on this general tour de table, why don't we adjourn until 9:00 a.m. tomorrow morning?

[Meeting recessed]

July 6, 1989--Morning Session

CHAIRMAN GREENSPAN. We are now up to Mr. Kohn's presentation on the long-term ranges.

MR. KOHN. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Quick question, Don: Of the 8 to 10 revisions, is there any systematic directional change in those?

MR. KOHN. I don't think so. Remember one year we lowered the bottom end of the M2 range; that was in 1988. Other years we have widened the range. I'm sorry, Mr. Chairman, I'm looking for--

CHAIRMAN GREENSPAN. Actually, Norm has given me a table.

MR. KOHN. It's the table I'm looking for but am having trouble finding. It's about half and half.

CHAIRMAN GREENSPAN. That's what I think.

MR. KOHN. Yes.

CHAIRMAN GREENSPAN. So, there are no systematic indications. Other questions for Mr. Kohn?

MR. JOHNSON. Don, I need a review; you may have mentioned it but go over it one more time. One of my concerns is that if we are beginning a period of declining interest rates, clearly, we're going to see behavior in velocity symmetric to the increase we've had over the period of rising interest rates; we're going to see a declining velocity growth. Would you review again, just as a rule of thumb, what the lags are on, say, a 100 basis point decline in interest rates? What would that do to M2 growth or to the M2 money demand I guess is the way to put it? What kind of lags are there before they catch up?

MR. KOHN. Well, the lags can last four or five quarters before the full effect is felt if you just have a one-time decrease. I'd say about 100 basis points at the current level of rates probably would give you, say, about 1 percentage point or something like that over four quarters. Dave? I'm sorry, it would be more like 2 percentage points in the growth rate over a couple of quarters.

MR. JOHNSON. So 100 basis points would yield 2 percentage points in growth over a couple of quarters?

MR. KOHN. Yes. In other words, if you did it this quarter, in two quarters you'd have a maximum of about 2 percentage points more growth; and then it tapers off after that. The whole effect--

CHAIRMAN GREENSPAN. What we really want to know is the change in the level at the end of the cone.

MR. KOHN. Right. I would say that's probably about 1-3/4 percentage points in four quarters, judging from this table.

MR. JOHNSON. One of my concerns is that, given the lags, if we started a sustained period of declines in interest rates--even if we were shooting for 5-1/2 percent or so nominal growth next year--we might end up having to absorb 2 full percentage points or more of extra M2 growth because of the effects on velocity just to hit that nominal target. If that's what you think--

MR. KOHN. If you think the economy is going to be weaker--that its underlying demands are weaker or that inflation will be coming down faster and therefore interest rates will be lower--then I do think that. We have a 6-1/2 percent growth projected for relatively flat interest rates. There's no question in my mind that if you thought rates would be declining significantly and you wanted to get approximately the same nominal income growth, for the same rates then you'd be threatening the upper end of the 3 to 7 percent range.

CHAIRMAN GREENSPAN. Which suggests that we may be 9 out of 11 [next February].

MR. JOHNSON. That's what I was saying.

CHAIRMAN GREENSPAN. Further questions for Mr. Kohn? If not, I'd like first to discuss whether this Committee desires merely to reaffirm the 1989 ranges and then go on to discuss the 1990 ranges. I would appreciate it if someone would like to initiate a point of view on the 1989 ranges.

MR. JOHNSON. I'm in favor of extending the existing ranges.

CHAIRMAN GREENSPAN. Let me put it to you--

MR. ANGELL. Yes, I would not want to change the '89 ranges.

CHAIRMAN GREENSPAN. Let me reverse the question. Is there anyone on the Committee who feels it might be desirable to change the '89 cone? If not, I would entertain a motion to reaffirm it. Do we have one?

MR. JOHNSON. So move.

MR. ANGELL. Second.

VICE CHAIRMAN CORRIGAN. Second.

CHAIRMAN GREENSPAN. Without objection. Let's now move to the more important issue of views on the tentative ranges for 1990, emphasizing the tentative aspects of this and recognizing that our history is not one in which we have been committed irrevocably to whatever it is that we choose at this meeting. President Black.

MR. BLACK. Mr. Chairman, I think you have taken away the easy part of the problem. The 1990 ranges are really where I suspect we will have most of our differences here. And I think that's the more important part of [our decision]. A lot of this depends on how one views the ranges; there are different ways that one can look at this. To me, the most important thing is that the ranges are our signal to the public, and I hope a reasonable signal, of what we plan to do over the next four to six quarters to achieve the long-run objectives of monetary policy. Accordingly, I think it's very important that the ranges we select for 1990 make it crystal clear to the public that this current apparent softening in final demand is not going to divert us from our objective of trying to restore price stability over the long run. We have made a lot of progress on this and I think we've had excellent monetary policy for a long time now. But we still have the underlying inflation rate at around 5 percent, so we still have some distance to go on that. All of us, obviously, would like to achieve price stability with a minimum of disruption in the economy. But I think price stability really has to be our primary--and I would say our single overriding--long-term goal. I think the greater the public's confidence in our commitment to that end, the less the short-term disruptions are going to be.

So, in my mind, it's highly desirable that we reduce the range for M2 further in 1990 to maintain the credibility that we've won over such a long period of time. So, I strongly prefer alternative III. What that means to me, really, is that we want the underlying rate of growth of M2 to come in somewhere around the 4-1/2 percent midpoint of the 2-1/2 percent to 6-1/2 percent range, which would be consistent with what I think we've been trying to do for a long time. Now, I recognize that the staff's baseline forecast for M2 for 1990 is 6-1/2 percent. That means, of course, that a 2-1/2 to 6-1/2 percent range doesn't give us a lot of leeway for error on the up side. But frankly, I wouldn't be unduly concerned if interest rate movements or some other temporary factor did cause us to come in above that, as long as we were reasonably confident that that was temporary and it was something that we could explain to the public.

If you'd permit me to add one final point, Mr. Chairman: Every time we go through this exercise, I become more and more convinced that we really need to change our targeting procedures to look at this on a multi-year basis. Several of us have made this point in the past; and I'd like to suggest again that we take a look at that because, given base drift, this seems to me a pretty inefficient way to target on the long-run objectives on which I think we all agree. I would like to see us, if we can agree on that, make some kind of move in that general direction.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. I'm very sympathetic to Bob Black's perspective for the long run. It seems to me that we do want to get those ranges for M2 down to 1 to 5 percent. A 1 to 5 percent range is where we have to be in order to be even close to credibility in regard to price level stability. If we mean that, it just seems to me that's where it has to be. I do believe, however, that we ought not to back up. That is, I want to see us only lower ranges and never raise them. And, with Don's report, I believe that it would be prudent for us for 1990 to keep the 3 to 7 percent range. It seems to me that we will once again have a period in which the expectation will be for rising interest rates, and that's when we ought to go down another leg to 2 to 6 percent. So, Mr. Chairman, I prefer the long-run strategy II, which is very conservative. But I prefer alternative II for 1990, because I'm not willing to go down and then exceed it on the top side. If there's one thing that I feel very strongly about after 3-1/2 years here, it is that whenever we have erred on the extremes on M2 growth, with 9 percent M2 growth and 2 percent M2 growth--even though we may say M2 growth, V2 doesn't give us precision--we have been buying a little lack of stability. So, my preference is alternative II with a commitment to getting to 1 to 5 percent before my term is over.

MR. BLACK. I can't really quarrel with that. I was just hoping, as I was telling Don before the meeting, that he could come up with as good reasons why we ran over the target as he did in his recent memorandum--which I thought was excellent work--explaining why we ran so low. If he could, then I could be pretty well satisfied with that. He certainly eliminated some of my worries about this unduly slow rate of growth we've had in M2 recently. It has been about 3 percent adjusted.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, our analysis suggests that M2 and M3 are likely to grow in 1990 at a slightly less rapid rate--5-1/2 to 6 percent--than the Bluebook [forecast]. But even that slower growth would be consistent with not changing the ranges, at least on technical grounds. I do think, though, that it is important that we reduce the ranges because I think it does send a message to the public regarding our resolve gradually to lower the rate of inflation over time. I think the strategy II that was outlined is the one that we ought to be pursuing over the longer term. Therefore, I would support the suggestion of President Black to pursue Bluebook alternative III, which I think would still be at least within the range of what I would expect the growth of the two aggregates to be next year.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, given our experience with the aggregates this year, I think it's very difficult to forecast the outcome for the balance of the year, much less for 1990. I think the memo that Don sent out analyzing what has happened so far really was an excellent way of looking at what has happened. But that certainly is after the fact, and it doesn't give me, at least, any real assurance as to how these aggregates are going to perform in the future. But in the interim, it does seem to me that the signal effect of the ranges that we select really is very, very significant. There is an interesting quote in the Bluebook on page 17 which says "But only alternative III involves a further reduction in all the current money ranges and might seem most in accord with reinforcing the Committee's longer-term commitment to price stability." I think that is a very significant statement. To say anything else, really, in terms of the choice of the range would be a mistake. Therefore, I would be very strongly in favor of alternative III for 1990. If in fact things work out this year along the lines that Don is suggesting, we do have--as apparently has been the case in the past--the opportunity to change the ranges in February. Clearly, if a change were appropriate at that time, then we would do it. But I think in the interim it would be important to signal our continual commitment to price stability. And I think alternative III accomplishes that.

MR. GREENSPAN. President Syron.

MR. SYRON. Mr. Chairman, I think that policy has been a mixture of luck and skill and has been remarkably effective. And I think the challenge before us is to continue that process. The comments that have been made on signals are highly appropriate in terms of the point that it's certainly necessary that we lower some of the ranges. But I find that I'm somewhat sympathetic to what Governor Angell said, particularly given that we think it is likely, were we to adopt alternative III, that we subsequently would have to raise the range for M2. With that [being] our suspicion--and it is mine--I would prefer alternative II.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, I would identify myself with those who think that the announcement effects of these ranges are highly important. At the same time, as a technical matter, I think we need to make these ranges as realistic as possible; and given the staff forecast for growth of M2 and M3, I would favor alternative II. I think there are two signal effects that we need to give out now because of the uncertainty of the economic climate. Clearly, we need to send a signal that we are not letting up on our fight for price stability. But on the other hand, given what not only the staff forecast but other forecasts are showing for the economy, I think we also need to send the signal that we are not altogether tolerant of recession. And I think alternative II gives you the best of both possible worlds in that regard. So, I think we'd be better off at this time tentatively adopting alternative II. Then, if the economy turns out to be stronger, we can move to alternative III for M2 in February.

VICE CHAIRMAN CORRIGAN. [Since the Chairman is out of the room], you're about to witness the first official act of the Vice Chairman of the FOMC in 25 years. [Secretary's note: Chairman Greenspan returned]. Mr. Chairman, I just told the Committee they were about to observe the first official act of the Vice Chairman of the FOMC in 25 years. I was about to call on Mr. Stern.

CHAIRMAN GREENSPAN. Why don't you do so?

MR. BLACK. He did it and he did it very well!

MR. BOEHNE. But Jerry, that brought the Chairman back very quickly!

CHAIRMAN GREENSPAN. You say he didn't fumble?

MR. BLACK. You'll have to speak more quietly next time, Jerry, if you want a longer reign!

VICE CHAIRMAN CORRIGAN. Mr. Stern.

MR. STERN. Thank you, Mr. Vice Chairman. I'm sensitive, as I think everyone is, to the emphasis on the long-run objective of price stability. But from my perspective, I think this is the time to acknowledge our uncertainty about 1990. I think it's possible to oversell this signal effect with regard to the ranges. It's more important, in my mind anyway, where we actually come out rather than what our announcement is as to the particular ranges at this point in time. Where my uncertainty about the outlook and the associated growth in the aggregates for 1990 lead me would be simply to adopt the

1989 ranges for 1990. I find it a little awkward to lower, say, the M3 and debt ranges and maintain M2, as under alternative II, for example. It seems to me that that suggests we know more than we do--that we're in a position where we can lower some ranges and not others. And I find it difficult to go down that path. It just seems to me that at this point in time we don't lose much by simply reestablishing the 1989 ranges for 1990 recognizing, as already has been pointed out, that we're going to get another look, or two looks, at that later this year and in February. I happen to believe that we're certainly going to learn a lot over the next six months about prospects for 1990, and I'd want to use that information.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Well, I don't think this is the time for a real extended philosophical discussion. But simply to say that our objective is price stability greatly oversimplifies what a central bank is all about. It seems to me that what the central bank is all about is sustainable prosperity. Over the longer pull, probably the most important contribution that we can make to that is price stability. But that to me is a means to an end, not an end in itself. So, in terms of sending out signals, I think that our signal ought to be one that says we are trying to have a sustainable prosperity. To go down willy-nilly in a mechanical way just for the sake of sending out a signal that we're committed to long-run price stability covers over a lot of the uncertainty that we see. If I were in your position, Mr. Chairman, in trying to sell some aggregate measurements I think I would want to stress the uncertainty--that we are committed to bringing inflation down but we also don't want to have a recession; we're committed to a soft landing. And in that kind of environment, it seems to me that tentatively adopting the 1989 ranges for 1990 would make sense. From a technical point of view, I would think that as we go through 1990 we're going to be in the alternative I to alternative II range. I don't see that alternative III is terribly realistic. By simply adopting the 1989 ranges at this point we tend to straddle alternative I and alternative II; and we can then make what modifications we want in February to make them more realistic to the economy at that point.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I would join those who agree that the announcement effect is important. But because of the uncertainty about where we're going to end up in 1989, adopting the 1989 ranges for 1990 with the opportunity to look at them again in February makes sense to me. That is not exactly alternative II in the sense that alternative II does drop the ranges of both M2 and debt. That doesn't make much sense to me. I would just adopt the current ranges. I do have some sympathy, however, with the proposal of Bob Black that we move to a multi-year targeting procedure to avoid this base-drift problem that likely will occur at the end of this year and into next year.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I think Gary and I were reading off the same sheet of notes. In a long-term sense, I'm in sympathy with alternative III. Eventually, we've got to get those ranges down. But

I don't think this is a time right now when we need that announcement effect. In other words, I don't think our credibility in terms of commitment to price stability is in question now. And, as some people have pointed out, there's a risk: If we take [the ranges] down now and go back up we have actually adversely affected our credibility. Secondly, we have some evidence to indicate that it would be hard to hit them; we may be right at the upper end. And I agree with what Gary said: that's where we really hurt ourselves. If we set the range and then don't meet it, I think that could have an adverse effect. In any case, I come out waffling between alternatives II and III, basically. And I think probably the best answer is to acknowledge that uncertainty just by adopting the '89 ranges and refining them in February.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I find myself very much down the same track as the last several speakers. There is a high degree of uncertainty here that I think we need to recognize. I certainly appreciate Ed Boehne's point that long-run price stability is a means toward the larger end of sustainable prosperity. In terms of signal effect, I think there are other signals that are important to send to the market and to the economy and the most important may be stability of performance on the part of the Fed. Moderation and balance would be some of the hallmarks of achieving that stability signal. As a consequence of all of those things, I would urge that we maintain the current ranges.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I would support sticking with the current ranges and carrying them over into next year. I would use the arguments I used last year at this time: that there are uncertainties and that there is no great [harm] in carrying these over because we do have another crack at them. As I think Mike Kelley said, it's better to present the appearance of stability rather than zigging and zagging. However, if we are going to change them, the direction I would go in, frankly, is toward alternative I--for a couple of reasons. One is that I hope we do get some additional M2 growth as interest rates come down. Secondly, talking about base-drift, I went back and looked at this table: in 1987 M2's actual growth was 4.1 percent, which was outside the low end of the range; that was followed by growth last year of 5.2 percent, which was within the range but below the midpoint; and so far this year M2 is growing below a 2 percent annual rate. So, if we look at this over a longer period, it seems to me that there is some point at which maybe we ought to say we should be making up a little of this growth that we haven't achieved in the past and that we did think at the time was a reasonable objective. So, I could go with either carrying the existing ranges forward or alternative I. Thank you.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I favor carrying over the 1989 ranges because I think we'll need the room.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, I would go with alternative III because if we don't do that I think there could almost be an implied reading that we're willing to accept inflation in the 4 to 5 percent range. And I'm not sure that we want to leave that implication. I think we all are having a bit of a sense of foreboding regarding what the economy is actually going to do. But it's still a little anticipatory. I think to reverse what we have set in place over time is probably going to be read as a little more significant than some of the others think. If it becomes necessary early next year to make an adjustment and to move the ranges up, it seems to me that that would be done on the basis of knowledge in fact existing at that time, as opposed to tone and feel and a suspicion at this point. And I could justify an upward move if circumstances, in fact, were there to dictate that.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. I agree with a lot of the other comments. I favor extending the current [M2] range of 3 to 7 percent for 1990. I find that acceptable, although I do think there is some risk that we may test the upper end of that.

CHAIRMAN GREENSPAN. That is extending the '89 ranges for all three?

MR. JOHNSON. Yes. I'm just saying alternative II; I can't remember now what the other two were.

MR. ANGELL. Alternative II lowers M3 and debt.

MR. JOHNSON. Alternative II is what I favor; I can live with that. I agree with Gary that I don't see exactly how we make this twist on M3 and debt but I've never paid any attention to those anyway. I can accept alternative II.

CHAIRMAN GREENSPAN. But you would take unchanged because you don't care. Is that correct?

MR. JOHNSON. That's right; I would take that too. I do agree that in the long run the ranges should come down. I think Governor Angell is right that 1 to 5 percent probably makes sense in the longer run. If you're going to have nominal GNP that's consistent with something like price stability, and if the long-run trend on M2 velocity is around 0, then you want an M2 range that has a nominal GNP associated with price stability and you've got to be in that area somewhere. But I think we're a ways from that. And I think, as Ed Boehne said, one of our major functions is to avoid destabilizing the economy in the process of seeking this goal of price stability. So, for those reasons, the 3 to 7 percent range for '90 makes some sense, even though I think we could find ourselves well above that target if we go through a sustained period of declining interest rates. But I think it's a reasonable target and worth trying to hit.

I can't help making one last comment, though, on this whole exercise about monetary aggregates. The way in which we conduct monetary policy, these monetary aggregates are simply passive proxies for what the economy generates through money demand. This is not a money supply process. We are setting interest rates and the economy is reacting to those interest rates and it's demanding money; and that's the way it works. We are not setting any money supply goal and supplying that amount of reserves to make sure [we achieve it]. I'm not saying I disagree with that; I'm simply saying that that's the way it works. And we shouldn't kid ourselves and think that we're supplying levels that are being generated through our policy. I couldn't help that last comment.

MR. BLACK. It is a modern-day version of the real bills doctrine.

MR. JOHNSON. I'd have to think about that.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Listening to the discussion, I hear a lot of words about long-term price stability objectives. I could have heard the same thing last year when I sat here. The inflation rate is still up there; it's probably higher than it was last year at this time. If you look at the Board staff's strategies for 1988 through 1991 there's very little difference in the inflation rate. The average is a range of 4.1 to 4.6 percent whether we are tight, easy, or stay the same in terms of the baseline. If you take the Board staff's baseline forecast and try to run it forward to see when we get to price stability, it takes at least a decade to do that under their baseline forecast. Now, if that's the case and that's really what we're looking at, then I think we shouldn't kid ourselves that we're after price stability because we're not. If we follow that path we're after controlling inflation at the current rate. If we're comfortable with that then I think we ought to say that. If we're not then I think we ought to do something more aggressive in terms of moving toward price stability, and that includes [going to] multi-year targeting so that we don't have base drift problems. Otherwise, next year we will be at the same point with a different set of concerns about the short term and pushing off the long term. So, unless we tie our hands somewhat--like a portfolio manager at a bank might by requiring insurance against stock losses to be put in place--we're going to continue to drift with the economy and with the vagaries of international developments.

So it seems to me that, at the minimum, we ought to go to alternative III, 2-1/2 to 6-1/2 percent, if the signal is important. The idea that we might have to raise it--really, when you take a look at the half point differential, it's relatively small. It's not likely that the difference between 3 to 7 percent or 2-1/2 to 6-1/2 percent is really going to cause much trouble. But if we put any value on signaling, then we ought to go for 2-1/2 to 6-1/2 percent, because we're likely to miss that 1/2 point mark anyway and it's not a big problem for us. I think this is a very important session for us every year because it's our only chance to look ahead 18 months. And that's what it's all about. That's the range in which policy is going to impact the inflation rate and the economy. If we've been too tight in the past and we've made a mistake and the economy is already heading down--well, that's history. Rushing into the breach now with lower interest rates is only going to produce more inflation down the road for us. So, I think we ought to tie our hands a little with respect to long-term targets and we ought to have tighter targeting. I'm in favor of alternative III.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. Where I come out is very close to where Gary Stern was--and for the reasons he gave, which are as good as any. That would be the '89 ranges for '90.

CHAIRMAN GREENSPAN. For all three?

VICE CHAIRMAN CORRIGAN. Yes. Having said that, let me just add a comment or two. I have to say that I have become increasingly skeptical, bordering on cynical, about the usefulness or reliability of these money supply measures as targets or indicators of monetary policy, notwithstanding the wonders of P*. In this specific and immediate context I'm not nearly as concerned as I think some are about the slow growth of M whatever over the recent past or, indeed, over several years. I don't want to get into a big discussion of that but I would simply say that one of the reasons I'm not as concerned is that when I look at the very broad measures of credit availability--credit growth, debt growth, and L growth--all of those things are behaving in quite a satisfactory way. In my mind, at least, all this financial innovation does play a significant role in accounting for the abnormal gap between M growth, however measured, and these broader measures of debt or credit or overall liquid assets, including nonbank liquid assets. So I'm just not quite as concerned.

Also, let me make a brief point in the context of Mr. Boehne's comment about a means to an end. I ask myself the question in the context of current policy: Is it possible, first, that the rise in the inflation rate has stabilized--that it's not going up anymore? There's a reasonable chance that that's true, but I don't think it's baked in the cake. But even if you assume it is baked in the cake, then the next question I have to ask myself, which is very relevant to this 18-month period, is: What would it take to buy back the acceleration in the inflation rate that we have had over the past 18 months? Forget about long-term price stability for the moment; just ask yourself what it would take to get back to where we were. Is there any plausible set of reasons to believe that we could recapture what we've lost without a fair amount of slack having to develop in the economy?

CHAIRMAN GREENSPAN. You're saying excluding the oil price effect?

VICE CHAIRMAN CORRIGAN. That's right. Maybe there are some things working in that direction; certainly, international competition is one. But history seems fairly compelling on this point: it's awfully hard to see how you can get a deceleration of the inflation rate, even by a percentage point or so, without some slack in the economy. And I think that is another aspect of this goal of price stability. It's nice to talk about it, but I am very skeptical that we can even achieve that intermediate goal of buying back what we've already lost without having to incur some real costs, much less get back to genuine price stability of 1950's vintage or something like that. So, I think Mr. Boehne's point is right on the mark, and we have to be realistic about what is feasible and what is not. Anyway, I can certainly live with the '89 [ranges] for '90.

CHAIRMAN GREENSPAN. A lot of issues have been raised here, and I think it's very clear that without exception they are all focusing on some way to eventually bring the inflation rate down significantly below where it is. I think the differences within the Committee are basically tactical rather than strategic. I must admit that I come out in an area which is either alternative II or '89 repeated, largely because--leaving aside the inflationary questions--the credibility on money supply growth is something I don't think we have a problem with. I think President Melzer [stated] it quite correctly; the ability of this institution to hold money supply at the very nominal growth rates of the last two years I think has put us in a position different from the Bundesbank, for example, which has been having a terrible problem of going off the other end. But however one looks at this, at some point we're going to have to confront the issue of inflation stability or price stability; either the markets are going to do it to us or we're going to have to come to grips with that. I don't think we have to in the immediate period; but we may find, when we're reviewing the '90 targets again in February, that that issue is going to be right in front of us and we're not going to be able to duck it terribly much.

Well, as I count up the various views, the critical mass is basically to stay with the '89 ranges temporarily as tentative numbers. I don't know whether or not those who are in favor of alternative II feel comfortable with that or not, but it's sort of half-way there. Because of the comments that I heard, I think it would be [appropriate] for somebody to move the continuation of the 1989 ranges for all three variables--the two Ms and debt--for 1990.

MR. JOHNSON. So move.

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Well, let's take a formal vote.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
Governor Johnson	Yes
President Keehn	No
Governor Kelley	Yes
Governor LaWare	Yes
President Melzer	Yes
Governor Seger	Yes
President Syron	Yes

CHAIRMAN GREENSPAN. Okay. That brings us to the next order of business, which is our standard short-run discussion. Mr. Kohn.

MR. KOHN. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Mr. Kohn?

MR. BOEHNE. You made the point that the markets have built into current rates a quarter point drop in the funds rate rather promptly. A quarter point from what base? Where do you--

MR. KOHN. I think about 9-1/2 percent. We've said 9-1/2 to 9-5/8 percent, but it's averaged closer to 9-1/2 percent and I think that's about where the markets think it is.

CHAIRMAN GREENSPAN. Other questions?

MR. HOSKINS. Let me just follow up on the one Manley asked earlier. If you were to lower rates 50 basis points, you would expect M2 by the fourth quarter, or by December, to be growing at 8 percent?

MR. KOHN. That's correct. You can see that in alternative A in the Bluebook. We have 8 percent, actually, from June to September.

MR. PARRY. June to September?

MR. KOHN. June to September. And that would encompass a strengthening pattern of M2 growth over that period. Consequently, by the time we got to the fourth quarter I think it would be in the 8 percent range or [even] higher.

MR. ANGELL. The fourth quarter to December would be what?

MR. KOHN. Quarter IV to December under alternative A? I don't know. Quarter IV to September is 3.7 percent, so my guess--

MR. ANGELL. Well, it'd probably be about 4-1/2 percent on alternative A to December. Is that about right?

MR. KOHN. Right, something like that.

MR. PARRY. No, it's 3-3/4.

MR. KOHN. That's to September; but then to December--

MR. ANGELL. If you maintain that you're going to get more kick.

MR. KOHN. Yes. My guess is that it may be closer to 5 percent--closer to the midpoint of the range.

MR. MELZER. Don, in the Bluebook and in some comments yesterday and today there has been a fair amount of discussion about what the market has built in, in terms of expectations. I don't view this as particularly unusual--that at the time policy is perceived to be on the move for the market to get ahead of itself--or particularly damaging if the expectations are not ratified. Would that be consistent with your view of the past? This isn't particularly unusual is it?

MR. KOHN. Well, it certainly is not unusual for them to be speculating about a change in monetary policy about the time you folks are sitting in this room meeting. My sense is that the intensity of the speculation and the immediacy and size of the expected rate movement is a little larger than normal. We have had some pretty strong upward sloping yield curves and expectations; one can think back only six months or less about some pretty immediate movements on the other side. I don't have a measure of how intense this is but I have the sense that the expectations are quite firmly held. It's not totally unusual. And they can go both ways with this.

MR. MELZER. Well, I'd be cautious about the extent to which we let that influence what we do; that's mainly what I'm saying.

MR. KOHN. I think that's right.

CHAIRMAN GREENSPAN. Any other?

MR. JOHNSON. I'll just follow up on that. I agree--

CHAIRMAN GREENSPAN. No, these are questions, not--

MR. JOHNSON. Well, this is a reaction to that. I think it's true that the market is discounting a fairly immediate 25 basis point move. But if you go a little further out--and I agree with what you're saying, Tom--the market is discounting more than a point in the bill market. And I don't--

MR. KOHN. Well, it's 3/4 of a point, I think.

CHAIRMAN GREENSPAN. It's not more; probably a mechanical estimate of what the bill rate today is implying is 8.8 percent on the funds rate.

MR. JOHNSON. There is normally about a 3/4 point spread, if you just take the average between the Treasury bill rate and the fed funds rate; and the Treasury bill rate now is about 7.75 percent.

MR. KOHN. And I think that [translates to] about 8-3/4 percent; the mechanical translation varies with the level of rates.

MR. JOHNSON. What is the rate?

SPEAKER(?). 8.8 percent.

CHAIRMAN GREENSPAN. 8.8 percent.

MR. JOHNSON. Okay, I'm sorry.

MR. KOHN. It varies with the level of rates, Governor Johnson, because you have to make some estimate for a marginal state tax rate--since bills are exempt from state taxes--as well as the coupon equivalent kind of [adjustment].

MR. JOHNSON. Sure. What I'm saying--

MR. KOHN. And the mechanical translation of 7-3/4 percent [on the bill rate] is about 8-3/4 percent [on the funds rate].

MR. JOHNSON. Yes, I think that's about right. I'm saying that's what the bill market has built in. Now, it clearly looks like an overshoot to me of where we want to be; but I'm simply saying that's where the market is.

MR. KOHN. One sense of where this yield curve is you can see on Chart I of the financial indicators that I have; it's really a minus, as of Friday of last week. But you can see that we have had some upward slopes in yield curves, at least measured this way, that are larger than the downward--

CHAIRMAN GREENSPAN. Any further questions for Mr. Kohn?

MR. STERN. Don, are there any reasons why you may be more or less confident about the path of M2 over the next 6 months than usual?

MR. KOHN. Well, I'm never very confident; but I must say that the response of M2 in June and over the last couple months was roughly about what we expected. Particularly if I take out the demand deposit component, which has had its own special influences with the compensating balances and whatnot, M2 is running stronger than we projected at the last meeting, and that's consistent with a slightly lower interest rate and a bounceback. The June performance reassures me somewhat that we are on an upward trajectory here and are more likely to come back within that range.

MR. ANGELL. But, Don, there is a possibility that the sucking down of those balances was abnormal in April and May and that there was some bounceback effect. So, it seems to me that there's some uncertainty as to whether or not that 6-1/2 percent [growth] will be maintained.

MR. KOHN. I agree, certainly. And we have built in a very modest [response]--I think about 1/2 percentage point--just arbitrarily assuming that it would get back in over 6 months into our forecast. On the other hand, as we go forward, even if rates were to stay at this level or something like it, we do have a little more of the influence of the recent decline in market rates coming in. So, we'd expect those two factors together to have a slight downward impact on velocity.

CHAIRMAN GREENSPAN. Any questions? Governor Seger.

MS. SEGER. Since some people outside follow the reserve aggregates--I realize we don't target them but they have [dropped] more than we expected, I believe, since last summer--how would you expect them to perform over the rest of this year?

MR. KOHN. We have the monetary base growing at about 3 percent this year, so we have it bouncing back. Because we have M1 essentially unchanged over the last half of the year, that dominates the reserve aggregates; we have them growing from June to December. But on a Q3 to Q4 basis they are essentially unchanged. And we have currency growing at about a 5 or 6 percent pace. So I think the reserve aggregates would tend to flatten out and the base would tend to grow a little faster, the base being 2/3 or 3/4 currency.

MS. SEGER. But you do think the decline in the reserve aggregates would cease under alternative B?

MR. KOHN. That would be our expectation on the basis that the decline in M1 would cease.

CHAIRMAN GREENSPAN. Further questions? President Keehn.

MR. KEEHN. Questions or--

CHAIRMAN GREENSPAN. We're still on questions. President Black.

MR. BLACK. Don, in your chart 9 where you have P above P*, is that a significant difference that would [lead] you to think that that's some indication for us that it might not [unintelligible]?

MR. KOHN. Well, as noted in the Bluebook long-run strategy section, we have P very slightly above P* here. We would expect this to be roughly consistent with Mike's Greenbook forecast stretching out to 1991, which was a very, very small deceleration of inflation. It was eerily similar to the staff baseline forecast.

MR. BLACK. I like that adverb.

MR. KOHN. I think in the Bluebook we said "interestingly;" I wanted to say "eerily."

CHAIRMAN GREENSPAN. Anyone else? Don, am I correct in sensing that this particular period seems to have far more anticipation in it than anything in the recent past? It's not only federal funds expectations but the size of the changes in the long end of the bond market. Are we looking at something which is the result, in part at least, of the increasing size of the financial services industry and the extent to which there is a great deal more activity and anticipation and players in the game?

MR. KOHN. I think there's a trend over time. One of the questions raised was: Does that trend in the activities of, say, pension funds in the stock market--and I assume in the bond market too--add to volatility? Do people tend to move from one side of the ship to the other--

CHAIRMAN GREENSPAN. The derivative instruments are also crucial to this whole game.

MR. KOHN. I think that the academic findings are, as we heard at President Guffey's conference last summer, that volatility is greater than can seem to be explained by fundamental factors in the market. Whether this has gotten worse over time, with the pension funds and financial services--that's the question. I think it's more of an open question. We have had other periods--one can think back to a year ago when we were starting to tighten--in which expectations were very strong and the market bond yields moved up from, say, February through March; we were in this 7-1/2 or 7-3/4 percent area in February of 1988 and we were at 9 percent within a couple of months. So I'm not sure that--

CHAIRMAN GREENSPAN. Well, at least I remember the bill rate rising really sharply against the funds rate in that period.

MR. JOHNSON. It did. You've got--

CHAIRMAN GREENSPAN. Not as much as this.

MR. JOHNSON. Well, it closed the spread quite narrowly a couple of times.

CHAIRMAN GREENSPAN. Which in a sense was implying another 100 basis points.

MR. JOHNSON. No, not quite that much; but when we were perceived [as] behind by the market in catching up to inflationary expectations we did get a fairly significant closing of the spread.

CHAIRMAN GREENSPAN. I'm not opposing it, I'm--

MR. JOHNSON. I don't think it ever has been discounted a point over the funds rate.

MR. KOHN. I do think this movement, say, since late '88 has been unusual. I'm looking at a chart of the bill rate and the funds rate now. We had similar kinds of movements in early '85--this sharp up and down. There are some [periods] like that, but in the last two years, say, the size of the movement is fairly unusual.

MR. JOHNSON. You could argue that that's related to the speed with which the Fed moves with the market.

CHAIRMAN GREENSPAN. True enough. Unless there are other questions, I think we can get to the substantive issue. But it does strike me that what is happening here is that the markets essentially have responded very dramatically to the expectation that the economy is turning and that we will respond, with necessity coming in behind. And in an odd way it has made the urgency of our response somewhat muted because the economy doesn't run off the funds rate; it runs off the long-term bond rate and the bill rate and all of the other related instruments. However, the question that I think confronts us is: How do we respond to what the evidence out there shows? I personally am a little concerned, as I indicated yesterday, about whether [unplanned] inventory accumulation will show up. There's no question that the data per se do not show any inventory backing up. But I've been through too many business cycles in my business career to have remembered making exactly that statement just prior to a slip in final demand which all of a sudden is unearthed and backs up a good deal of inventory. And all of a sudden we find ourselves with some general weakness. I wouldn't be particularly concerned were it not for the fact that, at this stage, I do think the money supply data--even though projected with some optimism to strengthen--are really quite restrained. And if there is one thing the central bank has to take due notice of, it is the Vice Chairman's concerns, which I generally share, that it is required of us to maintain financial aggregates in some acceptable pattern. That's really the reason why we have the cones.

The question that confronts us is the issue of how we should move. Frankly, I would be inclined at this stage, with the new marginal calculation made by Don Kohn, to move the borrowing; I guess seasonal borrowing requirements are down by $50 million, which would be the equivalent of 25 basis points on the funds rate. I ask myself: Why not more? And I think more [of a move] is potentially risking the type of problem that Governors LaWare and Johnson raised yesterday. I'm concerned that the worst thing that can happen to us, as far as policy is concerned, is that we are perceived to be easing too fast and in a manner which would open up the possibilities of inflationary expectations. It's hard for me to imagine how we are going to get the long-term bond rate down significantly from here unless the economy eases up quite significantly. But if we are dealing with a situation in which there is a belief that the Fed is opening up the money supply valve and that we're on our way down, I think we are risking the type of instability [we want to avoid]. That really would be quite counterproductive to an endeavor to just come off the pressure we've been imposing because, if we get a major response in inflation expectations, which would drive long-term interest rates higher, rather than soften the weakness in the economy and try to create support, we could inadvertently do precisely the opposite. I can't say to you that I know that, in fact, it would occur that way. But, looking at the way the markets have behaved just in recent days, there is a fragility and an instability out there. And I think the argument that Governor LaWare raised yesterday is one that we should be focused on. I'm not sure I come out exactly where he comes out on policy as a response to that. But the question of not creating instability, I think, is crucial for us. So, I would be reluctant at this stage to try to move all the way to "A," which would be a full $100 million decline in the borrowing requirement, for fear that we might end up doing precisely the reverse of what we would be endeavoring to do--if the Committee decided that it wanted to move somewhat in the direction of ease.

MR. JOHNSON. How would you feel if we moved 25 basis points and bond rates fell further?

CHAIRMAN GREENSPAN. You mean the interest rates?

MR. JOHNSON. Yes.

CHAIRMAN GREENSPAN. I would feel quite comfortable. That would suggest to me that the markets' view of the Fed's anti-inflation credibility remained in place.

MR. JOHNSON. I think that's right. Maybe it would stiffen it; I think that would be the impression.

CHAIRMAN GREENSPAN. Well, let me put it to you this way. Were it not the case, and the economy continued to be soft, I think we could probably safely move another notch.

MR. JOHNSON. Okay. That's what I'm saying.

CHAIRMAN GREENSPAN. But I wouldn't want to prejudge that.

MR. JOHNSON. No, I think that's--

CHAIRMAN GREENSPAN. I think it would be dangerous to do so. So, I would like to recommend [borrowing] sort of half-way toward "A" with symmetric language, if for no other reason than I can't think of any purpose for using other than symmetrical language.

MR. FORRESTAL. Sorry. Did you say symmetric or--?

CHAIRMAN GREENSPAN. Symmetric. In other words, I would initiate at this meeting moving half-way toward "A," meaning a decline of $50 million in the borrowing requirement, which in our new calibration is the equivalent of 25 basis points [on the funds rate], and staying with symmetric language. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I can support the formulation that you put on the table, Mr. Chairman. But I do think that the body English on it is important. I completely support your suggestion that we've got to be careful here. Therefore, I think the symmetric language is also important for the reasons that you've stated. In terms of the more cautious approach I would simply add: (1) that it still, as I said earlier, is not clear to me that the inflation rate necessarily has stopped rising--and even if it has, I think we still could get a couple of months of lousy numbers; and (2) as an extension of that, and for external reasons as well, I at least am prepared to run some risk of an economy that is on the slow side for some period. But I think the thrust of your prescription is precisely right.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, to my mind we're in a very, very difficult period at the moment and I think the formulation of policy is more difficult than usual. If you step back a bit and look at our strategy, the strategy that we formulated a year ago was well conceived and I think it has been well executed. I think we have pretty well gotten the results we wanted--that is, in the sense that we have brought the economy down to a more sustainable level of performance. Unfortunately, inflation is still at too high a level. If I believed my own forecast I would be more apt to stay where we are. But I recognize that my forecast for GNP next year is an outlier; and given that outlier position, I have much less confidence in that forecast than I ordinarily would. So, I think your prescription is the right one. I think we have to be careful not to move too quickly and undo inadvertently what we have achieved through the strategy that we developed last year. I would certainly support your formulation, including the symmetric language. But your point about the comments that were made yesterday concerning fragility and the consequences of policy is very, very important, because I think the consequences of moving too quickly and letting inflation move up would be perverse and would achieve exactly the kind of things that we certainly want to avoid. So, I think going slowly the way you suggested is the proper stance for policy at the moment.

CHAIRMAN GREENSPAN. President Parry,

MR. PARRY. Mr. Chairman, I think it's appropriate for us to move very cautiously at this point. It's clear that the current rates of inflation are a problem; and even more of a concern is the fact that underlying inflationary pressures are likely to remain a problem for quite a while, whether you [accept] the forecast of the Greenbook or some of the others that have been talked about around the table. So, it seems to me the biggest mistake would be to move too aggressively and, therefore, I could support the proposition that you put on the table.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Mr. Chairman, I have a great deal of sympathy for the policy prescription that you advocated for the following reasons: first, given that our long-term goal is price stability, I'm not all that unhappy about where we are right now; and at least for the next couple of quarters I'm not that unhappy with what the Greenbook forecast has embedded in it in terms of the behavior of rates. Knowing the uncertainties that exist in this world, I think it is very important to move gradually, for the reasons that other people have mentioned, and to adopt an approach or continue an approach in which the Chairman has a fair amount of flexibility. There are things that could happen in the intermeeting period that would substantially change how one would read the economy. So, I very strongly support that.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I agree, essentially, with those who have already spoken with respect to your proposal. If I were to believe our own forecast for the quarter immediately ahead, quite likely I would opt for alternative B with symmetric language. Essentially, the question in my mind is whether or not we really have the slowing that was detailed yesterday in the numbers that Governor Johnson cited--whether or not that is going to continue throughout this quarter or whether we will pause and get a reacceleration and therefore an inappropriate further dropping of short-term rates at this point. Then we'd have to turn it back around. But given that uncertainty, your proposal to move cautiously seems to me to be appropriate--symmetric language of the directive and between alternatives A and B. One thing that isn't clear to me, however, is how the borrowing level would be treated. I know there has been an explanation; I guess I just didn't understand. It is dropped by $50 million under your proposal, Mr. Chairman. Given that the seasonal borrowing is roughly $500 million or a bit above and we have been at $600 million as a borrowing level, are we talking about $550 million or are we talking about staying at $600 million?

SPEAKER(?). 600.

CHAIRMAN GREENSPAN. What I'm doing is calibrating off what Don Kohn has indicated.

MR. KOHN. It'd be roughly $600 million.

CHAIRMAN GREENSPAN. I think they recalibrated the [current level] to $650, so technically, I guess it comes down to $600 million.

MR. GUFFEY. 600?

CHAIRMAN GREENSPAN. Yes.

MR. JOHNSON. You recalibrated the $650 million for what alternative?

MR. KOHN. For alternative B.

CHAIRMAN GREENSPAN. For "B."

MR. PARRY. And $550 million for "A."

MR. JOHNSON. Okay, right.

MR. ANGELL. But you expect that to be consistent with [a funds rate of] 9-1/4 to 9-3/8 percent?

CHAIRMAN GREENSPAN. That's correct.

MR. JOHNSON. It doesn't sound like the old formula, but that's okay.

MR. KOHN. No, Governor Johnson, it isn't because of the--

MR. JOHNSON. That's all right.

MR. KOHN. It [includes] seasonal and adjustment borrowing--

MR. JOHNSON. Yes, okay.

MR. GUFFEY. Mr. Chairman, I'd just like to add one other caveat. We do have a fairly important number coming out on Friday--that is, the employment number. Rather than moving to the lower level that you are suggesting before that number comes out, I think I'd wait and take another look before the--

CHAIRMAN GREENSPAN. Let me suggest this: If the number turns out to be a major surprise, on the up side perhaps, we would be well advised to have a telephone conference on the basis of that.

MR. GUFFEY. I would agree; that's very satisfactory.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, given the current situation and the accumulation of evidence in the economy, along with the current conditions in the markets, I think the policy prescription that was outlined is just right and I concur with it.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Yes, I concur with that policy; I believe that a borrowing range associated with a 25 basis point move at this point in time is the most prudent. We really have been very fortunate, it seems to me, that the market has given us so much credibility that long-run rates have moved to where they have moved. And it seems to me that we should have the objective of somehow or other getting at least the soft landing in the housing industry and that's most clearly done with long rates, not with short rates. It just seems to me that fixed mortgage rates need to be in the single-digit area in order for us to have the soft landing. Now, for those who may wonder how this fits with price level stability, I will share with you the commodity price annual rates of change charts that I've been following very, very carefully. As you can see, those smooth rates of change have had a very flat top on them; so I've been hesitant to call what I would say is a forecast of a downturn in the CPI year-over-year rate of change. But unless I'm totally wrong, the CPI year-over-year rates of change between now and October are going to be declining. And it's encompassing that that would permit me to want to--

CHAIRMAN GREENSPAN. There's a technical reason for that; the gasoline price we know is coming down and we have that refinery adjustment problem, which the seasonal does not pick up. Mike, what is that worth in the PPI? As I recall, it was not small.

MR. STOCKTON. No. We're expecting that to take about 4 cents a gallon off gasoline prices by the September-October period. So there's about a 4 percent decline just from that as well as some weakening in gasoline margins over and above that. Once that's in place, we're expecting CPI prices to be [rising] 0.2 to 0.3 percent for the summer months of July, August, and September. And for the PPI [we expect a] zero to 0.1 percent rise for a few months in late summer, early fall.

MR. ANGELL. I'm aware of those technical changes and that's why I have such a low forecast for the CPI in the second half. But I did want [others] to be aware of the fact that some of that is a one-time deal and will not necessarily follow through. But the work that Peter Von zur Muehlen has been doing--and he will have a working paper for the American Ag-Econ Association and the U.S. Department of Agriculture meeting in Baton Rouge, Florida later this month--has shown that these smooth commodity prices have been very significant in regard to forecasting changes or peaks in the CPI. And that's what I guess I'm staking my reputation on that the CPI will respond.

MR. BOEHNE. Be careful, Wayne.

CHAIRMAN GREENSPAN. The technical data are supporting that.

MR. ANGELL. I never stake my reputation without some other help like that!

MR. JOHNSON. But, Wayne, this is ex-oil. Would you be forecasting an ex-oil CPI turning point?

MR. ANGELL. No, I don't think--

MR. JOHNSON. Well, I think it's reasonable.

MR. ANGELL. Yes, I feel confident that that will take place. But we have to understand that changing the growth of the money stock does show up in these commodity prices. It took a while for those slow money growth rates to show up but now they are showing up. And I think that's encouraging. What we want to avoid, it seems to me, is the risk of too severe a slowdown, which would then be followed by overdoing it in regard to money growth rates on the up side. So, I think caution is the right word. And I expect the markets to be stabilized somewhat by less than maybe the markets expect. And then I think we need to take another look. Now, I would prefer asymmetric language just because--as you know, in March I thought we should have been symmetric and in May I thought we should have been asymmetric--remember, these minutes are released 6 weeks from now. So, I think it's better to have the 6-week release make us sound a little smarter than it does when we're so reluctant to move in a direction on the symmetry that I think is needed. It's not going to show up now, anyway; and if it turns out that we are wrong we will have demonstrated that we didn't make any moves. But I favor your proposal.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I know your preference is to go between "A" and "B" but I think I would go all the way to "A." First of all, I don't think that a 50 basis point change in the fed funds rate is all that startling. Going upward we went 50 and 75 basis points without even winking or blinking at all. Also, I'm not so sure that all the markets have incorporated only a 25 basis point easing by us. This morning I heard the early financial news on TV and some of the stock market commentators were talking about the impact of expectations of lower interest rates on the stock market. Again, I don't know if these folks are right, but they were building the stock market story on substantial declines in interest rates. Secondly, we heard all these pieces of evidence presented yesterday about the slowing in the economy, and I certainly agree with all those. Frankly, I think that there's going to be much more slowing going forward, regardless of what we do today, because I don't think the actions today are going to impact the economy one way or the other for probably the rest of this year.

Earlier we were talking about the importance of announcement effects; probably there are a thousand people in the country who know what we do at the FOMC, and maybe 500 of them know what the ranges are for monetary growth. But there are 500 and some people down at the other end of Constitution Avenue who are going to be following what goes on in the real economy. If the economy weakens even further and they start hearing from the folks at home about rising unemployment rates and so forth, then I'm sure our Chairman here is not going to be the man of the hour when he has to go down there and meet with them--because I think they will wonder why we didn't see what was going on, or if we saw it, why we ignored it and didn't react. So, as I said, I would prefer alternative A.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I support your policy recommendation, Mr. Chairman. I don't think we came out too far apart in our conclusion, because I think destabilization in either direction is bad.

CHAIRMAN GREENSPAN. I said that because you had not commented; it was more omission rather--

MR. LAWARE. So, I certainly support the 25 basis point change in rate and the symmetric language.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, you made my talk for me except that you made it much better than I would have. But, I would like to suggest one thing. It probably won't meet with a lot of acceptance but I'd like to see the monetary aggregates moved up in that list of things that might temper what we're doing in the intermeeting period. Rather than the unemployment and employment figures [to be released] this Friday or inflation figures coming later on, I think this is really the crucial thing. And I think it's important that we do keep [money growth] moving up; it has been very weak for a long time and unless we get to change that, frankly, I think we're going to run into trouble before very long. So I'd like to see that moved up to the first place. But otherwise, I'm right with you on this.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. I'd be very close to Bob Black's position. As I listen to the comments around the table, it seems that there is a view that the economy is softening. Certainly some indicators have [shown] that and some people are arguing that we ought to ease policy on that basis. A one-quarter-ahead forecast for real GNP has an error of plus or minus 2 percentage points around it. If you go out 18 months on inflation you find roughly the same error. The only point I'm trying to make is that we seem to be in the business of fine-tuning; that, I think, has led us into some problems in the past. If one is to support your proposition, I think the reason ought to be to ensure that we get Don Kohn's projected money growth for the second half. While I prefer to stay where we are on the hope and prayer that Don's forecast is accurate, I certainly would be ready to bias [policy] toward alternative A if the aggregates didn't come through. And I'd probably be more aggressive--along the lines of Martha's position.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I agree with what you suggested. I think caution is appropriate for the reasons that Lee expressed before. If we fall into the trap of short-term fine-tuning it could be very disruptive in the long run. So, I think the caution is appropriate and I think the symmetrical language conveys that as best we can.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I support your prescription.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I certainly support your prescription. I would like to suggest when it's in order--now or later--a reordering of the presentation of our list of concerns in the policy directive. Would that be in order now? Or would you prefer to do that later?

CHAIRMAN GREENSPAN. Since the issue has been raised late in this go-around, perhaps we ought to complete this and then go back to the question of ordering--unless somebody's vote or view would depend on that [unintelligible]. Governor Johnson.

MR. JOHNSON. I agree with the Chairman on his proposal, although my preference probably would have been 50 basis points on the funds rate phased in over two periods, because I do think caution is certainly needed in the immediate period. I think we ought to test how the market absorbs 25 basis points before we consider any further moves. As Don Kohn pointed out, if you go further out, the market clearly has discounted well over 50 basis points in terms of what they expect us to do over a period of time, which is certainly within the period between meetings. So, my preference would have been to plan to take another step based on how the markets developed between here and there. I generally think asymmetric language would be preferable, but I can go with the symmetry. I still want to express a concern, though. I think we always became quite concerned with where we were relative to the markets when we were tightening--when the markets perceived us to be behind on the inflation fight--and we moved fairly aggressively to catch up and even tried to stay ahead at times, which I think was critical to our gaining credibility. I think that problem works in reverse. If we lose the confidence of the markets that we are going to pursue a stable policy and keep up with changes and events, we're going to run the risk on the down side that we were worried about on the up side. I don't think we're there; but I think that problem is simmering out there for us. I don't think we're anywhere near finding ourselves in a situation like this, but the problem I worry about in the back of my head is that the Fed drove interest rates gradually down to 0 in the 1930s and it didn't do a blessed thing to stop the economy's decline. Getting into that kind of a mentality is a risky situation, so I think we need some [asymmetry] both on the down side and the up side. But I can go along with your funds rate.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. I would concur.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I think your suggestion for a 25 basis point drop in the funds rate is exactly what ought to happen. I would, however, take some issue with the [proposed] symmetry. I would prefer an asymmetrical directive for two reasons: first, I think the risk has shifted and there is more downside risk than there is upside risk in the economy and an asymmetrical directive would underscore that; and secondly, given the string of data that we have had in recent weeks that have been on the bearish side, it's difficult for me to imagine that we would tighten in the next six weeks. It would have to be a very dramatic turnaround in the data, and I think the probabilities of that happening are very, very small. On the other hand, what is most likely is that we will see a continuation of the bearish data and it wouldn't take nearly as convincing a string of information in that direction to warrant a further decline in rates. And when I consider the reasons why we usually have had asymmetrical directives, it seems to me that those two reasons have been high on the list.

CHAIRMAN GREENSPAN. Can we now get views on the issue of the position of the various elements which affect our directive? At the moment it reads: number (1) inflationary pressures; (2) the strength of the business expansion; (3) the behavior of the monetary aggregates; and (4) developments in foreign exchange and domestic financial markets.

MR. ANGELL. Mr. Chairman, before you go to the go-around I'd like to have reactions to another suggestion, and that is: It seems to me that "indications of inflationary pressures" is a defensive posture that was appropriate during the period that we knew we were going to be giving ground on inflation. I would rather have a more positive statement in the wording such as "progress toward price stability" rather than "indications of inflationary pressures."

CHAIRMAN GREENSPAN. Sounds like a reasonable suggestion. Does anybody object to that?

VICE CHAIRMAN CORRIGAN. I have trouble with it because I really have been concerned that we may be projecting this notion to the public and to the Congress--and I hope you're right with your commodity prices, Wayne--that there's a free lunch, or that we can get from here to there without having to incur some real difficulty in the economy. And I think that's very dangerous.

CHAIRMAN GREENSPAN. Let me suggest, then, that we withhold that until perhaps the next meeting when it would be on the table again--unless there's an objection to that--because that's the type of change which I think is an important change and should largely reflect the views in the Committee generally.

MR. ANGELL. Well, Mr. Chairman, the reason I raise it now is because you're about to prepare your Humphrey-Hawkins testimony. And I was thinking in terms of that testimony as well as this directive, which is going to be published six weeks from now. At this point in time the chances of our avoiding too significant a turndown, I think, depend upon our credibility; and I think that stronger language to a price level commitment will help the long-bond market more. That's the reason I raise it now.

VICE CHAIRMAN CORRIGAN. I don't have any trouble putting some words like that in the Chairman's testimony or even in the body of the directive itself. I don't know; maybe I misunderstood.

MR. ANGELL. Well, I guess I don't understand what you object to in terms of progress toward price stability.

VICE CHAIRMAN CORRIGAN. What I object to is that I think we are running a risk of creating an impression in the Congress and elsewhere that we are going to get to price stability in some easy, painless way. I just am very, very skeptical that that is possible. I'm skeptical that we can even get the inflation rate back down to 4 percent without having to incur some hardship.

CHAIRMAN GREENSPAN. That's why we do say in the directive, as Norm points out to me, that "the FOMC seeks monetary and financial conditions that will foster price stability, promote growth," etc.

VICE CHAIRMAN CORRIGAN. We probably should look at these--

MR. ANGELL. Well, can someone think of some other language that somebody doesn't object to?

MR. PARRY. What's your concern?

MR. ANGELL. "Indications of inflationary pressures" seems like a resistance approach. In other words, if inflation pressures don't get any worse it seems like maybe that's what we're after.

MR. HOSKINS. Isn't that what we've done?

MR. ANGELL. That's exactly what we've done.

MR. HOSKINS. My point earlier was if that's how it is, then we ought to start saying that.

VICE CHAIRMAN CORRIGAN. What if we say "taking account of progress in resisting inflationary pressures"?

MR. HOSKINS. As opposed to continuing to say "price stability," if [our objective] is really to maintain current rates of inflation then we've got to be honest about it and say that. If not, if we really mean price stability, then we ought to take actions to achieve that.

MR. ANGELL. But I would hold that when you look at the M2 growth path over the last 30 months this is an unprecedented M2 growth path for 30 months in the history of M2. We have never had a 30-month period of growth this low and this stable. And we've got time [lags]. So, it seems to me that we are going to have the burdens and the pain is going to show. You don't get there cheap. I guess I'm somewhat more optimistic in regard to what the record is than you are.

MR. JOHNSON. I agree with that.

CHAIRMAN GREENSPAN. Let me suggest one thing. When we publish any change in words it is going to get really very heavily evaluated at this particular turning point. I feel a certain sympathy for what you're saying, but perhaps what we ought to do is to--

MR. ANGELL. I'll be satisfied to do it next meeting.

CHAIRMAN GREENSPAN. Yes. Let's think about that, because I hate to make that type of decision which we don't mean to be all that significant but can be read to be rather significant. Let's try some formulations between meetings and perhaps come up with a better set of language. Let's leave this particular discussion strictly to the repositioning, if any, of what it is that we have in the directive with respect to our indicators. President Parry,

MR. PARRY. I'd like to address the repositioning issue. It seems to me that we still ought to keep some statement about inflation up front. I think we ought to remember why we moved "behavior of the monetary aggregates" to where it is. We had a lot of research, conducted by the staff, that indicated that the association between the growth of money and the economy was not sufficiently predictable or stable to rely on it to a great extent for use in terms of operating in financial markets. Without taking another look at whether or not the staff has changed their view on that, why should we move it up? In addition, if we do move it up to number 1, should we stop talking about the way we have been formulating our policy in terms of borrowed reserves?

MR. ANGELL. You want to take it to two, then?

MR. PARRY. I don't want to change it--not until some work is done that would support such a change. I don't understand what has changed in terms of our perception about the usefulness of money as a guide to the economy since all those studies were done.

MR. BLACK. When the federal funds rate comes down a little and the aggregates continue at the rate they have been going, I think the market will be scared very much by those developments. So, the reason I suggested moving that up a little is that they ought to know that we are concerned that the aggregates not stay that low forever, but rather that they should move up a bit from where they are. The work that Don and his associates did alleviates a lot of my worries about it because that work pretty well suggests to me around 3 percent, which might not be too bad. I don't think that [low growth] ought to go on any longer now; and I'd like the markets to know that if it doesn't begin to move a little we'll have to do something.

MR. PARRY. Are you suggesting that we try to monitor it?

MR. BLACK. I always suggest that.

MR. PARRY. Well--

CHAIRMAN GREENSPAN. At this particular point, I have an urgent phone call. I was wondering if we could break for coffee now and come back in a few minutes.

[Coffee break]

CHAIRMAN GREENSPAN. Governor Kelley you have the floor.

MR. KELLEY. Thank you, Mr. Chairman. I assume we're proceeding to discuss the ordering of our concerns.

CHAIRMAN GREENSPAN. Yes.

MR. KELLEY. I wanted to make a suggestion along that line, if I might. First of all, in the spirit of your comment that anything that goes into these directives that is different from what has been there heretofore is very carefully scrutinized, we should think about it carefully. In that spirit, my suggestion is more in the nature of putting something on the table rather than trying to push for its immediate adoption. I would suggest that we consider reversing the order of the first two of these considerations that appear in lines 63 and 64 of the operational paragraph and give more emphasis to the strength of the economy as opposed to inflationary pressures. This arises out of the notion, discussed here earlier today and before, that in monetary policy price stability is a very important and essential precondition to a larger end--that it's the means toward a larger end of sustainable growth. I think sustainable growth is driven by a wide variety of different factors as well as monetary policy in the interplay of all sorts of things. We carefully tried to assess the risks to our forecast and whether or not the economy might turn out to be stronger or weaker than the forecast. Everybody has slightly different views on that, but it does seem fairly clear and fairly consensual that the risks are for a slower economy than we have seen heretofore. That's not really my point; my point, as I tried to allude to yesterday afternoon, relates to the consequences of events falling out meaningfully on one side or the other of the consensus forecast on the economy. It seems to me that the consequences of the economy being somewhat stronger are not terribly severe. For one thing, it's hard to see the economy being very much stronger than the forecast given the 30 months of aggregate growth history that Governor

Angell alluded to earlier and given the nature of the incoming evidence on what's going on in the real economy. It's very difficult for me to see that inflation could get away from us in some way that we couldn't go back and reassess. On the other hand, if events fall out on the weak side, I think that the consequences are very asymmetrical in the sense that they could be much more severe than if they should turn out to be on the strong side. If we could be confident that we could fine-tune this soft landing and have a period of slow growth that would eventually, at some point down the line, begin to gradually turn up, that would be very nice. But we all know we can't necessarily count on being able to do that. And I am very concerned about the nature of the factors that Governor LaWare discussed yesterday afternoon that have to do with the fragility, particularly of the financial structure, at this time. I certainly don't think I need to go back over that; everybody is aware of that. But there are factors out there of very large magnitude, other than monetary policy, that could put us in a situation where we could have a downturn that could feed upon itself with very severe consequences in the larger picture of the economy and the society. Indeed, should we get into a severe recession with ballooning deficits it could turn out to be very counterproductive in making long-term progress toward price stability. So, it seems to me that largely as a result of the asymmetrical consequences of how events might turn out, this might be a time that we should give more priority overtly to what's going on in the economy relative to what's going on strictly in the narrower consideration of inflation. So I would propose for consideration, either now or later Mr. Chairman, that those first two considerations be reversed.

CHAIRMAN GREENSPAN. Well, having heard the beginning of this conversation and doing a little arithmetic, there are eleven members of the FOMC at the moment and five various elements, to which you have just added several more. Since whatever we do will be read very closely, I would feel very uncomfortable crafting that language now; I would suggest for the Committee's consideration that in the period immediately ahead Don Kohn contact not only the Committee members but all the other Presidents as well and see if we can lay before the Committee at our next meeting some alternatives which capture the type of issue you and others have raised to see whether in fact we do wish to make changes. I would think it's probably impracticable to try to make changes now, and I would offer as a consideration that we essentially think about this a little more because there's a lot greater sensitivity to this than we would like. And I think a little thought would be useful.

MR. KELLEY. Well, as I indicated early on, I entirely subscribe to that notion; but I did want to get that on the table.

CHAIRMAN GREENSPAN. Okay.

VICE CHAIRMAN CORRIGAN. I would not personally object, Mr. Chairman, if you choose to incorporate the gravamen of what Governor Kelley is saying even in your testimony where you're not as bound--

CHAIRMAN GREENSPAN. Well, the testimony is on the 20th and by then I think we will have gotten basically the thrust of this.

VICE CHAIRMAN CORRIGAN. We can leave these words where they are but try and get some--

CHAIRMAN GREENSPAN. I think it would be worthwhile--if there is going to be a table, as there invariably is, on the Committee members' and the Presidents' forecasts--to bolster that a bit by getting some of the characteristics of what the individual views in that table basically are and put them not only into my testimony but in the document as well. If there are no objections to that as a proposal I would like Norm to read us just the operational paragraph, which captures what I believe is the central tendency of the individual members' decisions. We do have a substantive issue on the language, which is not just arbitrary--whether we say the Committee seeks to decrease "somewhat" or "slightly" the existing degree of pressure. I would say the presumption is slightly, but is there a strong view either way on that question?

MR. JOHNSON. Well, the reality of it is clearly "slightly."

CHAIRMAN GREENSPAN. Well, we ought to be clear on that.

MR. BLACK. [Unintelligible.]

MR. JOHNSON. I would prefer "somewhat" but that would go with a different change.

CHAIRMAN GREENSPAN. Why don't you use "slightly."

MR. BERNARD. It would read: "In the implementation of policy for the immediate future the Committee seeks to decrease slightly the existing degree of pressure on reserve positions. Taking account of indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, somewhat greater reserve restraint or somewhat lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with growth of M2 and M3 over the period from June through September at annual rates of about 7 percent. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 7 to 11 percent."

CHAIRMAN GREENSPAN. Would you put that to a vote?

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
Governor Johnson	Yes
President Keehn	Yes
Governor Kelley	Yes
Governor LaWare	Yes
President Melzer	Yes
Governor Seger	No
President Syron	Yes

CHAIRMAN GREENSPAN. I gather that for those who wish to revise their forecast for submission in the Humphrey-Hawkins testimony and report it would be useful to have the revisions, if there are any, by July 12th. That's next Wednesday, I believe.

MR. ANGELL. How many did you throw out on both sides to get the central tendency?

MR. PRELL. The ones that I showed throughout that range--

MR. ANGELL. Three on each side?

MR. PRELL. We'll have to look at this again and see how the group decision was reached after we've seen the revised numbers.

CHAIRMAN GREENSPAN. The next meeting date is scheduled for Tuesday, August 22.

END OF MEETING